

Is Unlimited Liability Really Unattainable?: Of Long Arms and Short Sales

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I. INTRODUCTION

The wisdom of limited shareholder liability for corporate torts has recently been questioned.¹ Several authors have suggested that changes in tort law and, more important, increases in the amount of damage that can be caused by corporate torts, have made unlimited shareholder liability appropriate for corporate tort judgments.² The specific proposal that has received the most attention is that of Professors Henry Hansmann and Reinier Kraakman,³ who advocate a system of pro rata liability of shareholders for corporate torts.

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¹ As one author recently described, limited liability can distort the economic incentives of tort law:

Tort liability, and product liability in particular, has been justified by the economic incentives such liability places on actors to take the proper amount of care to prevent harm to others. Recently, a number of writers have pointed out that principles of limited liability, found most prominently in corporate law, undercut these incentives and indeed may encourage corporations to engage in unduly risky activities.

David W. Leebron, *Limited Liability, Tort Victims, and Creditors*, 91 COLUM. L. REV. 1565, 1565 (1991) (footnotes omitted). See also Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879, 1880 (1991). This issue was also touched on briefly in Paul Halpern et al., *An Economic Analysis of Limited Liability in Corporation Law*, 30 U. TOR. L.J. 117, 119 (1980), but that article was primarily concerned with corporate contractual debts, rather than tort judgments. See also PHILLIP I. BLUMBERG, *THE LAW OF CORPORATE GROUPS: TORT, CONTRACT, AND OTHER COMMON LAW PROBLEMS IN THE SUBSTANTIVE LAW OF PARENT AND SUBSIDIARY CORPORATIONS* §§ 5.01–5.02, 8.01–16.04 (1987) (discussing veil-piercing and shareholder liability in the context of parent-subsidiary relationships).

² See, e.g., Hansmann & Kraakman, *supra* note 1, at 1880 (“Changes in technology, knowledge, liability rules, and procedures for mass tort litigation have for the first time raised the prospect of tort claims that exceed the net worth of even very large corporations.”); Leebron, *supra* note 1.

³ Hansmann & Kraakman, *supra* note 1, at 1896.

Under their scheme, tort liability would attach to shareholders of both closely-held and publicly-traded corporations when it appeared likely that claims exceeding the value of the corporation would be filed.⁴ Shareholders under their plan would not, however, be jointly and severally liable, as most previous commentators have assumed,⁵ but would be liable only for the share of corporate tort debt proportional to their share of equity ownership.⁶

Although it is unlikely that all advocates of limited liability have been swayed by the arguments of Professors Hansmann and Kraakman,⁷ responses to their proposal have for the most part addressed not the desirability of unlimited liability but its feasibility.⁸ Their article has prompted two lengthy replies,⁹ each arguing, for different reasons, that a pro rata unlimited liability system would not work. Professor Janet Cooper Alexander takes a procedural approach, contesting the claim of Hansmann and Kraakman that unlimited liability could be imposed by the states individually. Professor Alexander contends that if a single state imposed unlimited liability, corporate tort

⁴ *Id.* at 1896-98. The specific statement of the rule by Hansmann and Kraakman is that liability would attach "when the corporation's management first became aware that, with high probability, such claims would be filed." *Id.* at 1897. The liability date could, of course, be no later than the date of the actual filing of claims. *Id.* To avoid the problem of corporate liquidation to avoid tort liability, Hansmann and Kraakman would also impose liability if the corporation dissolved without leaving a contractual successor. *Id.* & n.48.

⁵ See, e.g., Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 92 (1985); Halpern et al., *supra* note 1.

⁶ Hansmann & Kraakman, *supra* note 1, at 1892-94.

⁷ Indeed, the recent statutory authorization in many states of limited liability companies (LLCs), see, e.g., N.Y. LIM. LIAB. CO. LAW (McKinney Supp. 1995); DEL. CODE ANN. tit. 6, ch. 18 (1993 & Supp. 1994), suggests that if there is a national trend, it is toward *more* limited liability, rather than less. The significance of the issues discussed in this article is increased by this movement, though. As of this writing, three states, Massachusetts, Vermont, and Hawaii, have not yet authorized LLCs. Dennis S. Karjala, *Planning Problems in the Limited Liability Company*, 73 WASH. U. L.Q. 455, 455 n.2 (1995). It is unclear how torts committed by LLCs will be treated outside their states of creation. It is possible that states in which LLCs are not authorized might attempt to impose liability on the members of out-of-state LLCs, and this article sheds light on whether such attempts would succeed.

⁸ A recent student paper does contest the merits of Hansmann and Kraakman's proposal, however. See Michael P. Coffey, *In Defense of Limited Liability: A Reply to Hansmann and Kraakman*, 1 GEO. MASON U. L. REV. 59 (1994).

⁹ Janet Cooper Alexander, *Unlimited Shareholder Liability Through a Procedural Lens*, 106 HARV. L. REV. 387 (1992); Joseph A. Grundfest, *The Limited Future of Unlimited Liability: A Capital Markets Perspective*, 102 YALE L.J. 387 (1992).

creditors would find it difficult to enforce that liability due to jurisdictional¹⁰ and choice-of-law¹¹ issues. Specifically, she argues that courts would be unwilling either to assert jurisdiction over out-of-state shareholders or to apply the unlimited-liability state's law to corporations chartered in other states. Professor Joseph Grundfest takes a different tack. Relying in part on the extension of Professor Alexander's arguments to the international arena, he argues that, as a practical matter, unlimited shareholder liability would be undermined by the ownership of risky equity outside the United States and the creation of new derivative financial instruments that would effectively recreate a limited-liability regime for U.S. investors.¹²

The upshot of the responses by Professors Alexander and Grundfest is that it is impossible, under current procedural law and in light of financial-market innovation, for a state to impose a regime of unlimited shareholder liability. This is, at least from one perspective, a surprising conclusion. Corporate torts are made possible only by the investments of the corporation's shareholders. If shareholder liability were unlimited, that substantive economic relationship between shareholder and tort would be transparent; that is, there would be no corporate veil. In its absence, it is unclear why there should be difficulty in recognizing sufficient connection between shareholders' investment decisions and corporate acts to satisfy jurisdictional and choice-of-law requirements. Professors Alexander and Grundfest in effect argue that, regardless of the liability rules of the states in which a corporation does business, its shareholders can shield themselves with the corporate veil established by—for Professor Alexander—the state of incorporation¹³ or—for Professor Grundfest—the country in which the shareholder resides.¹⁴ I argue here that

¹⁰ Professor Alexander's jurisdictional arguments are discussed *infra* part III.

¹¹ Professor Alexander's choice-of-law arguments are discussed *infra* part V.

¹² Professor Grundfest's arguments are discussed *infra* part VI.

¹³ This is true explicitly of Professor Alexander's choice-of-law arguments, where she contends that the law of the state of incorporation should prevail over the law of the state in which the corporate tort was committed. *See infra* part V. It is also true implicitly of her jurisdictional arguments, where she claims that a shareholder purposefully avails itself only of the laws of the state of incorporation, and has no jurisdictionally significant contacts with the states in which the corporation does business. *See infra* parts III–IV.

¹⁴ As described in part VI *infra*, Professor Grundfest's financial-market arguments rely primarily on the existence of a class of foreign shareholders who are, as he puts it, "attachment-proof." If a court in the United States, rejecting Professor Alexander's arguments, issued an unlimited-liability judgment against a corporation's shareholders, foreign shareholders would be attachment-proof only if courts in their own countries refused to enforce the U.S. judgment. Such a refusal would presumably rely on a decision that unlimited liability was against the foreign country's public policy. *See infra* part V.C.

this view is plausible only if one remains wedded to the traditional conception of the corporation as a limited-liability entity.

Professor Alexander, throughout her article, assumes that shareholders are passive investors who cannot be charged with knowledge of, and hence responsibility for, the acts of the corporations that they own.¹⁵ There are two reasons to think that this assumption is inaccurate.¹⁶ First, even under the current limited-liability regime, many investors, including at least most institutional investors, are quite aware of the business activities of the corporations in which they invest, and of where those activities take place. Second, and more important, if unlimited liability were instituted, shareholders would become more knowledgeable regarding the business activities of the corporations in which they invest. As will be argued below,¹⁷ if shareholders did in fact know of their corporation's activities in an unlimited-liability state, that state should be able to obtain jurisdiction over them, even if the corporation were chartered elsewhere. The choice-of-law question is perhaps a more difficult one, but at least for publicly-held corporations¹⁸ the interests of states in which the corporation does business are probably greater than those of the state of incorporation.¹⁹ That is especially so because unlimited-liability judgments would be paid by the corporation's shareholders, not by the corporation itself.

Professor Grundfest's assumptions are more theoretically plausible, but they are also empirically unsupported. His arguments assume that there is some class of shareholders for whom the possibility of an unlimited-liability judgment would make *no* difference in their investment decisions.²⁰ Professor

¹⁵ Alexander, *supra* note 9, at 409. ("The shareholders' consent [to liability] could not be implied from the corporation's decision to do business in the state for two reasons: First, because the shareholders lack control over (and even knowledge of) the corporation's activities, and second, because the shareholders' decision to purchase stock has no connection to the forum state.").

¹⁶ These points are discussed further *infra* part IV.A.

¹⁷ See *infra* part III.

¹⁸ As I discuss *infra* part V.B.2, I believe that the choice-of-law decision tilts more toward the state of incorporation for closely-held corporations. Hence, for those corporations I think that unlimited liability is less viable; for close corporations, I think that the usual piercing-the-veil rules are a more appropriate avenue to determine shareholder liability.

¹⁹ See *infra* part V.

²⁰ See Grundfest, *supra* note 9, at 393 ("In the end, transaction costs in the capital markets might increase [as a result of financial-market liability evasion techniques], but stock market prices would not fall to reflect the risks associated with proportionate liability.") (footnote omitted). Aside from the questionable proposition that unlimited-

Grundfest would claim that such shareholders could be investors from other countries whose courts would not enforce U.S. unlimited-liability judgments. But this claim, in turn, relies on two other, related assumptions: that it will be certain that an unlimited-liability judgment could not be enforced against those investors, and that they will therefore be willing to pay no less for equity that might subject them to such a judgment than for equity that would not. In fact, though, the enforceability of an unlimited-liability judgment is unlikely to be so clear. Enforceability would vary over time, from corporation to corporation, and from country to country, and a shareholder could only avoid enforcement so long as she kept her assets out of reach of the United States courts.²¹ Furthermore, even if a foreign investor could indeed avoid enforcement, she could only sell her risky shares (at full price) to others who were similarly unreachable.²² Professor Grundfest neglects these risks and burdens that would fall on investors in risky equity, yet they would not be borne by those investors for free, so unlimited liability would still be effective.²³

The remainder of this article is divided into six parts. Part II sets the stage for the rest of the article by reviewing earlier experiences with excess shareholder liability, which neither the courts nor the financial markets have found as unmanageable as Professors Alexander and Grundfest suggest. Part III addresses Professor Alexander's jurisdictional concerns and concludes that they are overstated; the voluntary nature of the decisions of shareholders to invest in particular corporations doing business in unlimited-liability states would be sufficient to subject shareholders to jurisdiction. Jurisdiction would, however, require that shareholders were aware that they could be subject to unlimited liability, and Part IV describes why and how shareholders would in fact gain

liability risk would not lower stock prices, *see infra* part VI.A, the increase in transaction costs to which Professor Grundfest refers would itself lower the price of risky equity. Assume that investors believed that a particular risky stock was, if free of unlimited-liability risk, worth a particular price. If those investors, to make that stock truly free of liability risk, were also required to purchase the liability-evasion mechanisms that Professor Grundfest describes, they would lower the price that they were willing to pay for the stock by the cost of those evasion mechanisms.

²¹ *See infra* parts VI.A.1-2.

²² *See infra* part VI.A.3.

²³ It is true that its effectiveness might be only partial. To the extent that shareholders' assets were in fact unreachable, the compensatory goals of unlimited liability would not be met. To the extent, though, that the price of risky equity was reduced by the risks and burdens to investors of holding it, the reduced price both would have the risk-detering effect on corporate management desired by advocates of unlimited-liability and would cause more investors whose assets were reachable to buy, thus indirectly serving the compensatory goal as well.

that awareness. Part V discusses the more difficult inter-jurisdictional issues. Domestically, these issues include the limitations of the dormant commerce clause and of choice-of-law more generally; internationally, the choice-of-law question must take into account the difficulties of enforcing an unlimited-liability judgment that could be inconsistent with a foreign country's policies. Part VI then describes Professor Grundfest's financial-market arguments and explains why there is reason to think that the financial markets would not in fact enable shareholders to avoid unlimited liability. Part VII offers some final observations.

II. SHAREHOLDER LIABILITY IN PRACTICE

Excess shareholder liability is not unprecedented.²⁴ Until 1931, California imposed unlimited, pro rata liability on shareholders of both its own and other states' corporations,²⁵ making California law at the time quite similar to that proposed by Professors Hansmann and Kraakman. Although California's law was unusual, other forms of more limited shareholder liability have been common: double or triple shareholder liability (*i.e.*, liability for an amount equal to the par value of a shareholder's shares, or twice that value for triple

²⁴ For a general description of excess-liability statutes, see BLUMBERG, *supra* note 1, §§ 2.01-2.02.

²⁵ California's provision for unlimited liability was repealed as part of a complete superseding of California's corporation law in 1931. See Act effective Aug. 14, 1931, ch. 862, § 1, 1931 Cal. Stat. 1762, 1763. Prior to its repeal, the unlimited-liability provision read as follows:

Each stockholder of a corporation is individually and personally liable for such proportion of all its debts and liabilities contracted or incurred during the time he was a stockholder as the amount of stock or shares owned by him bears to the whole of the subscribed capital stock or shares of the corporation. Any creditor of the corporation may institute joint or several actions against any of its stockholders, for the proportion of his claim payable by each, and in such action the court must ascertain the proportion of the claim or debt for which each defendant is liable, and a several judgment may be rendered against each, in conformity therewith. The liability of each stockholder of a corporation formed under the laws of any other state or territory of the United States, or of any foreign country, and doing business within this state, is the same as the liability of a stockholder of a corporation created under the constitution and laws of this state.

Act of Mar. 20, 1905, ch. 339, § 1, 1905 Cal. Stat. 396, 396 (codified as CAL. CIV. CODE § 322 (Deering 1923)) (repealed 1931).

liability) was imposed by many states in the nineteenth and early twentieth centuries,²⁶ double liability for bank shareholders was a matter of both federal and state law into the mid-twentieth century,²⁷ and unlimited shareholder liability for unpaid employee wages persisted into the twentieth century, and survives still in New York and Wisconsin.²⁸ Moreover, individual companies have always been able to operate with unlimited liability, and at least one publicly traded company, American Express, did so until 1965.²⁹ These excess-liability arrangements presented no particular difficulties, either in the courts or in the financial markets.

The California corporate unlimited-liability law was considered by the U.S. Supreme Court on several occasions. In *Thomas v. Matthiessen*,³⁰ the Court faced an attempt by a citizen of California to recover from a citizen of New York on debts owed by an Arizona corporation in which the New Yorker was a shareholder.³¹ Despite the defendant shareholder's explicit agreement with the corporation that he would not be liable for corporate debts, and a corporate charter provision to that effect, the Court concluded the California law could be applied. The Court said that "a [corporate charter] provision exempting the stockholder [from liability] alongside of one authorizing the doing of business elsewhere cannot . . . be deemed an attempt to override the law of the place where the business is to be done."³² The Court pointed to the shareholder's explicit assent to the corporation's business in California, and held that by that assent the shareholder submitted himself to liability:

When the defendant authorized [business in California], he could not avoid the consequences by saying that he did not foresee or intend, or that he

²⁶ BLUMBERG, *supra* note 1, § 2.01.2.

²⁷ *Id.* § 2.01.3; see also Jonathan R. Macey & Geoffrey P. Miller, *Double Liability of Bank Shareholders: History and Implications*, 27 WAKE FOREST L. REV. 31 (1992).

²⁸ *Id.* § 2.01.4. The current New York law provides for joint and several liability with contribution of the ten largest shareholders of corporations whose shares are neither listed on a national exchange nor regularly quoted in over-the-counter markets. N.Y. BUS. CORP. LAW § 630(a) (McKinney 1986). The Wisconsin law provides for pro rata liability of all shareholders for up to six months of unpaid employee service. WIS. STAT. ANN. § 180.0622 (2)(b) (West 1992).

²⁹ Peter Z. Grossman, *The Market for Shares of Companies with Unlimited Liability: The Case of American Express*, 24 J. LEGAL STUD. 63, 65, 72-75 (1995).

³⁰ 232 U.S. 221 (1914).

³¹ The California statute permitted creditors to bring suit against shareholders directly. See *supra* note 25; see also, e.g., *Morrow v. Superior Court*, 1 P. 354, 354-55 (Cal. 1883) (en banc).

³² *Thomas*, 232 U.S. at 234.

forbade them. He knew that California had laws and he took his risk of what they might be, when, as we must hold, he gave his assent to doing business there.³³

Thomas appears quite clearly to say that a state can impose its own shareholder liability policy on even foreign corporations doing business in the state. The only condition on which the Court appeared to rely was the shareholder's knowledge of the California unlimited-liability statute.³⁴ The Court assumed for the purpose of its decision that "a provision for doing business in other States without any express reference to the possible difference in their law would not be enough to change the rule [of limited liability]."³⁵ The Court found liability, though, by concluding that the shareholder's intention that the corporation do business in California, together with his apparent awareness of California law, was sufficient to bind him. Professor Alexander implies that the Court in *Thomas* relied on an explicit assent by the shareholders to the California law, but that is not so;³⁶ the shareholder in

³³ *Id.* at 234-35. The Court reached a similar conclusion regarding the same law in *Pinney v. Nelson*, 183 U.S. 144 (1901), in which it relied on the corporate charter's explicit provision for doing business in California as an express contractual undertaking to apply California's laws. *Id.* at 150. The Court said that "[p]arties may contract with special reference to carrying on business in separate States, and when they make an express contract therefor the business transacted in each of the States will be affected by the law of those States, and may result in a difference of liability." *Id.* at 151.

³⁴ There are several suggestions in the Court's opinion that the defendant's explicitness in seeking to be free from personal liability was a response to the California law. See *Thomas*, 232 U.S. at 233 ("The Oak Knoll is near Pasadena in California, and the defendant and his associates intended the corporation to have the power to build and manage a hotel in that neighborhood and expected that it would do so, but intended their liability to be controlled by the laws of Arizona."); see also *id.* at 234 ("In this case the defendant expressed in writing his wish that the corporation should set up a hotel in California. It is true that he also desired and stipulated that he should be free from personal charge.").

³⁵ *Id.* at 234.

³⁶ To reach this conclusion, Professor Alexander says that the Court "relied on a pre-incorporation shareholder agreement to find that the shareholders had 'give[n] . . . assent [to be bound by California law] outside of the instrument of incorporation.'" Alexander, *supra* note 9, at 412 n.121 (quoting *Thomas*, 232 U.S. at 234). What the Court actually said, though, was that a shareholder "may give such assent outside of the instrument of incorporation and be bound by it." *Thomas*, 232 U.S. at 234. The Court then observed that the shareholder did not in fact do that, but instead "desired and stipulated that he should be free from personal charge." *Id.* The Court explicitly rejected the shareholder's desires, stating that those desires were "merely the not infrequent occurrence of a party bringing about the facts and attempting to prohibit their legal consequence." *Id.*

Thomas had in fact emphatically refused to assent to the California law, but the Court refused to allow him to set his own terms for benefiting from the corporation's business in California.³⁷

Thomas presented only a choice-of-law question, not a jurisdictional one, because the creditor brought suit in the shareholder's home state of New York. The Supreme Court apparently has not been faced with an attempt by a creditor to obtain jurisdiction in an excess-liability state over an out-of-state shareholder of a corporation incorporated elsewhere. The Court has, however, considered an attempt to *enforce* an excess-liability judgment against a shareholder over whom the court rendering the judgment did not have jurisdiction. In *Chandler v. Peketz*,³⁸ the Supreme Court considered a Colorado shareholder's jurisdictional challenge to an attempt by the receiver of a Minnesota corporation to enforce a Minnesota judgment that the receiver had obtained under Minnesota's double-liability statute. The Court rejected the challenge, observing that it had previously considered the Minnesota statute and held that shareholders were bound by a judgment under it:

[The judgment] is thus conclusive, although the stockholder may not have been a party to the suit in which it was made or notified that an assessment was contemplated, as the order is not in the nature of a personal judgment against him and he must be deemed, by virtue of his relation to the corporation and the obligation assumed with respect to its debts, to be represented by it in the proceeding³⁹

Chandler thus adopts an approach akin to that of a class action, in which an absent party can be bound by a judgment if she was adequately represented in the proceeding in which the judgment was issued.⁴⁰ The Court explicitly said that "the order levying the assessment is made conclusive as to all matters relating to the amount and propriety thereof, and the necessity therefor";⁴¹ that is, the judgment was conclusive as to matters regarding which the shareholder could be deemed to have been adequately represented by the corporation in the Minnesota proceeding.⁴² The Court emphasized that, as with a defendant class

³⁷ See *supra* note 36.

³⁸ 297 U.S. 609 (1936).

³⁹ *Id.* at 611 (citing *Bernheimer v. Converse*, 206 U.S. 516 (1907); *Converse v. Hamilton*, 224 U.S. 243 (1912); *Selig v. Hamilton*, 234 U.S. 652, 660 (1914); *Marin v. Augedahl*, 247 U.S. 142 (1918)).

⁴⁰ Cf. FED. R. CIV. P. 23.

⁴¹ *Chandler*, 297 U.S. at 610-11.

⁴² The Court also pointed out that notice of the hearing in the Minnesota action had been mailed to all of the corporation's shareholders. *Id.* at 611.

action,⁴³ the shareholder "[was] not precluded from showing that he [was] not a stockholder, or [was] not the holder of as many shares as [was] alleged, . . . or [had] any other defense personal to himself."⁴⁴ *Chandler* thus suggests that a similar class procedure could be used to adjudicate the pro rata liability of shareholders in any forum in which jurisdiction over satisfactory representatives of the shareholder class could be obtained.⁴⁵

Thomas and *Chandler* suggest that shareholder liability could be a workable plan, and empirical evaluations of excess shareholder liability bear that suggestion out. Professors Jonathan Macey and Geoffrey Miller conducted an extensive investigation of double liability for bank shareholders,⁴⁶ and they concluded that the system was quite effective.⁴⁷ Despite the expected problems of enforcing liability assessments in foreign states and of litigating against widely dispersed shareholders, Professors Macey and Miller report that over the lifetime of the federal double liability rule, 50.8% of each dollar assessed was collected.⁴⁸ That return ratio seems sufficient to conclude that the program was effective, and, indeed, Macey and Miller note that states with double liability had generally lower bank capital ratios than states that did not, suggesting that bank creditors "believed they could obtain repayment of some or all of their deposits by means of assessment in the event a bank failed."⁴⁹

The preceding paragraphs all address only the viability of unlimited (or excess) liability in the courts; opponents of unlimited liability also argue that it would have undesirable effects in the financial markets. Again, however, there is an empirical study that suggests otherwise. Peter Grossman has examined the trading activity in shares of American Express,⁵⁰ which until 1965 was organized as an unlimited-liability New York joint stock firm.⁵¹ Grossman

⁴³ See *infra* part III.B.

⁴⁴ *Chandler*, 297 U.S. at 611.

⁴⁵ As discussed *infra* part III.B, defendant class actions are used in this way in shareholder assessment proceedings.

⁴⁶ Macey & Miller, *supra* note 27.

⁴⁷ I am referring here to the system's effectiveness in recovering assessed losses from shareholders. Some of the conclusions of Professors Macey and Miller regarding the double-liability system's effectiveness in preventing losses have been challenged. See Howell E. Jackson, *Losses from National Bank Failures During the Great Depression: A Response to Professors Macey and Miller*, 28 WAKE FOREST L. REV. 919 (1993); Jonathan R. Macey & Geoffrey P. Miller, *Double Liability of Bank Shareholders: A Look at the New Data*, 28 WAKE FOREST L. REV. 933 (1993) (responding to Professor Jackson's critique).

⁴⁸ Macey & Miller, *supra* note 27, at 55-56.

⁴⁹ *Id.* at 60.

⁵⁰ Grossman, *supra* note 29.

⁵¹ *Id.* at 65, 72-75.

found that there was a regular market for American Express shares, with no suggestion of a concentration of shares in the hands of wealthy (or poor) shareholders,⁵² or in the hands of non-New York or non-U.S. investors.⁵³ He also found no indication that American Express's unlimited liability produced a discount in its share prices, even though at one time the company was sued for an amount of twice its net assets;⁵⁴ Grossman concludes that shareholders, perhaps unjustifiably, valued the risk of insolvency at zero.⁵⁵ Hence, where the cases discussed earlier suggest that unlimited liability could be effective when companies *do* fail, the American Express story indicates that unlimited liability need not present problems for companies that do not.

Admittedly, none of the experiences described above prove that unlimited liability would work. Both *Thomas* and *Chandler* preceded more recent decisions by the Supreme Court on choice of law and personal jurisdiction, as did the effective period of bank double liability,⁵⁶ and enforcement of the potential liability of American Express shareholders was apparently never required.⁵⁷ As will be shown below, though, *Thomas* and *Chandler* are quite consistent with the Court's later decisions, and both cases have been cited more recently by lower courts with no suggestion that their holdings have become less vital.⁵⁸ Moreover, the article by Professors Macey and Miller points out

⁵² *Id.* at 75–77.

⁵³ *Id.* at 81–82.

⁵⁴ *Id.*

⁵⁵ *Id.* at 78–83.

⁵⁶ After 1935, national banks were permitted to opt out of double liability after six months notice, and most states abolished double liability by 1944. Macey & Miller, *supra* note 27, at 38–39. *International Shoe* was decided in 1945. *International Shoe Co. v. Washington*, 326 U.S. 310 (1945). See *infra* notes 62–66 and accompanying text.

⁵⁷ Grossman indicates that at one point early in its existence American Express “faced a shareholder audit,” but he does not mention any assessment. Grossman, *supra* note 29, at 73.

⁵⁸ As discussed *infra* in the text accompanying notes 80–81, the Delaware Court of Chancery has recently relied on *Chandler*. *Thomas* was cited in *Joncas v. Krueger*, 213 N.W.2d 1 (Wis. 1973), which held that a Wisconsin statute making shareholders pro rata liable for unpaid debts to employees for up to six months services applied to foreign corporations. The court treated the question largely as one of statutory interpretation, but it did reject an argument that public policy prevents applying the law to shareholders of foreign corporations: “[S]uch policy finds no valid basis respecting the shareholders of foreign corporations doing business in Wisconsin; such shareholders should not be treated differently than shareholders of a domestic corporation. Wisconsin can impose such liability as a condition of doing business in this state.” *Id.* at 3 (citing *Thomas* and *Pinney*). But see *Armstrong v. Dyer*, 198 N.E. 551 (N.Y. 1935) (affirming, without opinion, an order of the appellate division dismissing a similar claim under a New York statute that was similar, but

that the courts can be quite flexible and sensible in dealing with the various problems that arise with shareholder liability,⁵⁹ suggesting that one should be skeptical of theoretical arguments claiming that shareholder liability cannot work.

III. JURISDICTION OVER NON-RESIDENT SHAREHOLDERS

As Professor Alexander points out, imposition of unlimited liability on out-of-state shareholders does present significant jurisdictional questions. However, her analysis of these questions is limited to several Supreme Court cases,⁶⁰ each of which is factually very different from the unlimited shareholder liability situation. If anything is clear in this area, it is that the jurisdictional issue is very fact-specific.⁶¹ Therefore, it is more helpful to examine how courts have treated cases that are factually similar to the one at hand, rather than to attempt to extrapolate from very different (though more authoritative) cases of the Supreme Court. This is not to say, of course, that the Supreme Court cases are irrelevant; it is only to say that to the extent that they present different facts, they can only be used as a source of general principles, not as a source of specific decision rules.

The first section below outlines the general rules that the Supreme Court has established for the personal jurisdiction inquiry. The second section describes how these rules might be applied if a corporation's shareholders were sued as a class. In a class action, it is possible, if not likely, that a tort creditor would need to establish personal jurisdiction only over representative shareholders, or perhaps only over the corporation itself. The third section assumes, in contrast, that jurisdiction would be required over all corporate shareholders individually. This section points out, though, that courts have typically found jurisdiction over non-resident defendants who knowingly assumed liability for debts related to the forum, even where the defendants had little other contact with the forum. I suggest therefore that, assuming that a

provided for joint and several liability); *cf. infra* note 198 (discussing *Joncas's* statement that to exclude foreign corporations from the Wisconsin law could deny employees of those corporations equal protection). Other examples of the application of state statutes applied to foreign corporations are given in Norwood P. Beveridge, Jr., *The Internal Affairs Doctrine: The Proper Law of a Corporation*, 44 BUS. LAW. 693, 703-09 (1989).

⁵⁹ See Macey & Miller, *supra* note 27, at 39-55.

⁶⁰ See Alexander, *supra* note 9, at 394-401.

⁶¹ See, e.g., *Burger King v. Rudzewicz*, 471 U.S. 462, 485-86 (1985) ("We . . . reject any talismanic jurisdictional formulas; 'the facts of each case must [always] be weighed' in determining whether personal jurisdiction would comport with 'fair play and substantial justice.'") (quoting *Kulko v. California Superior Court*, 436 U.S. 84, 92 (1978)).

corporation's shareholders knew of their potential unlimited liability, jurisdiction would similarly be found over them. Finally, the fourth section discusses the Supreme Court cases relied on by Professor Alexander and shows how the Court's statements in those cases are entirely consistent with jurisdiction over shareholders.

A. *Personal Jurisdiction: Fairness and Federalism*

The power of a state's courts over those who are not residents of that state is limited by the Fourteenth Amendment's Due Process Clause. The basic definition of those limits remains that set out by the Supreme Court in *International Shoe Co. v. Washington*:⁶² "[D]ue process requires . . . that in order to subject a defendant to a judgment *in personam*, if he be not present within the territory of the forum, he have certain minimum contacts with it" ⁶³ "Minimum contacts" remains the formal label applied to the jurisdictional test, but the intervening fifty years have brought substantive elaborations on the test, and its modern interpretation has been described by the Court as follows:

The concept of minimum contacts . . . can be seen to perform two related, but distinguishable, functions. It protects the defendant against the burdens of litigating in a distant or inconvenient forum. And it acts to ensure that the States, through their courts, do not reach out beyond the limits imposed on them by their status as coequal sovereigns in a federal system.⁶⁴

It is through these two "fairness" and "federalism" elements, and their familiar "fair play and substantial justice"⁶⁵ and "purposeful availment"⁶⁶ tests, that the due process test is now usually applied.

The fairness element predates *International Shoe*, which cited several earlier cases in holding that an *in personam* judgment against a defendant not physically present in the forum state must not "offend 'traditional notions of fair play and substantial justice.'"⁶⁷ The primary concern is the burden placed

⁶² 326 U.S. 310 (1945).

⁶³ *Id.* at 316.

⁶⁴ *World-Wide Volkswagen Corp. v. Woodson*, 444 U.S. 286 291-92 (1980).

⁶⁵ *International Shoe*, 326 U.S. at 316.

⁶⁶ *Hanson v. Denckla*, 357 U.S. 235, 253 (1958).

⁶⁷ *International Shoe*, 326 U.S. at 316 (quoting *Milliken v. Meyer*, 311 U.S. 457, 463 (1940)).

on a defendant by requiring him to litigate in the forum state.⁶⁸ However, as will be discussed below,⁶⁹ in the case of shareholder liability the burden of defending may not fall on the shareholders at all. Instead, the corporation itself might be required to defend the initial suit regarding the acts on which liability depends, and later suits against shareholders might be limited to the issue of their status as shareholder. In that case, the fairness element would not present a jurisdictional obstacle to unlimited liability.

The federalism element has been variously defined by the Supreme Court as one that the defendant must have “purposefully avail[ed] itself of the privilege of conducting activities within the forum State,”⁷⁰ or as one that the defendant must have “purposefully directed” his activities at residents of the forum.⁷¹ It is not, however, necessary that a defendant must have itself conducted activities in the forum state. As the Court said in *World-Wide Volkswagen Corp. v. Woodson*,⁷² if the cause of action “arises from the efforts of the manufacturer or distributor to serve, *directly or indirectly*, the market for its product in other States, it is not unreasonable to subject it to suit in one of those States if its allegedly defective merchandise has there been the source of injury to its owner or to others.”⁷³ As will be seen below, it is this test on which the jurisdictional issue here hinges.

B. Pursuing Shareholders Through a Defendant Class Action

An action to enforce unlimited shareholder liability would almost certainly be brought against either the corporate tortfeasor or a class consisting of its shareholders, or against both. Although Professors Hansmann and Kraakman do not specify whether they would require tort creditors to bring suit against the corporation, it would be logical to do so. Allowing creditors to pursue

⁶⁸ *World-Wide Volkswagen Corp.*, 444 U.S. at 292 (stating that “the burden on the defendant, while always a primary concern,” is to be considered in relation to other factors). This burden is necessarily a function of the practical realities of communication and transportation. See *McGee v. International Life Ins. Co.*, 355 U.S. 220, 223 (1957) (“[M]odern transportation and communication have made it much less burdensome for a party sued to defend himself in a State where he engages in economic activity.”); *Hanson*, 357 U.S. at 251 (“[P]rogress in communications and transportation has made the defense of a suit in a foreign tribunal less burdensome.”).

⁶⁹ See *infra* part III.B.

⁷⁰ *World-Wide Volkswagen Corp.*, 444 U.S. at 297 (quoting *Hanson*, 357 U.S. at 253).

⁷¹ *Burger King Corp. v. Rudzewicz*, 471 U.S. 462, 472 (1985) (quoting *Keeton v. Hustler Magazine, Inc.*, 465 U.S. 770, 774 (1984)).

⁷² 444 U.S. 286 (1980).

⁷³ *Id.* at 297 (emphasis added).

shareholders individually, as the California unlimited-liability law did, would give rise to needless duplication of effort and to unfairness. Moreover, creditors would no doubt prefer to resolve as many issues as possible in a single proceeding. The question then becomes whether the creditor would be required to establish jurisdiction over all of the corporate shareholders.

Although Professor Alexander argues that personal jurisdiction would be required over each defendant in a class sued for damages,⁷⁴ other commentators believe that jurisdiction over the named representatives of the class would be sufficient.⁷⁵ Some of this commentary predates the Supreme Court's decision in *Phillips Petroleum Co. v. Shutts*,⁷⁶ but the Court in *Shutts* reaffirmed its earlier holding that "a 'class' or 'representative' suit was an exception to the rule that one could not be bound by judgment *in personam* unless one was made fully a party in the traditional sense."⁷⁷ Although *Shutts* involved a plaintiff class, rather than a defendant class, it did not suggest that the rules for the two cases differed.⁷⁸ Moreover, in its discussion of the reasons

⁷⁴ Alexander, *supra* note 9, at 406 ("Due process would almost certainly require, however, that each *defendant* in an action for damages have minimum contacts with the forum state, even if sued as part of a defendant class.").

⁷⁵ See, e.g., 1 HERBERT B. NEWBERG & ALBA CONTE, NEWBERG ON CLASS ACTIONS § 4.51, at 4-200 (3d ed. 1992) ("Because a class action, involving either a plaintiff or defendant class, is a representative action on behalf of absent class members, personal jurisdiction over all class members is not required to reach a binding judgment as to the common issues decided in the class action.") (footnote omitted); Barry M. Wolfson, *Defendant Class Actions*, 38 OHIO ST. L.J. 459, 461-62 (1977) ("An analysis of the historical development of the defendant class action . . . reveals that, assuming adequate representation, this action is an exception to the general due process mandate.") (footnote omitted); cf. RESTATEMENT (SECOND) OF JUDGMENTS § 41(2) (1980) (providing that "[a] person represented by a party to an action is bound by the judgment even though the person himself does not have notice of the action, is not served with process, or is not subject to service of process"); One commentator has said that such a conclusion is necessary.

[D]efendant class actions would generally be impossible if courts had to obtain personal jurisdiction over every class member, instead of just the named defendant, in order to bind the entire class. *Hansberry v. Lee* resolves this tension by establishing that a class action may bind absent parties consistently with due process only if their interests receive adequate representation.

Note, *Defendant Class Actions*, 91 HARV. L. REV. 630, 638 (1978) (footnotes omitted).

⁷⁶ 472 U.S. 797 (1985).

⁷⁷ *Shutts*, 472 U.S. at 808 (citing *Hansberry v. Lee*, 311 U.S. 32, 40-41 (1940) (citing *Pennoyer v. Neff*, 95 U.S. 714 (1878))).

⁷⁸ But see *infra* note 88.

why the jurisdictional requirements for absent members of a plaintiff class are relaxed relative to those of (nonclass) defendants, the Court focused on the burdens of defending against a suit in the forum state,⁷⁹ burdens which would not be faced by an absent shareholder defendant who was represented either by the corporation or by representative shareholders.

This is, in fact, how suits for shareholder assessment are currently handled: Suit is brought against the corporation to determine the common obligation of shareholders, and then shareholders are pursued individually for their portions of that common obligation. The Delaware Court of Chancery quite recently approved such a procedure with the following comments:

Imagine a case in which a corporate receiver petitions a court in the corporate domicile for an order adjudicating that an assessment against holders of stock is appropriate and fixing its amount. The receiver then takes her judgment to a foreign jurisdiction in which a shareholder who was not a party to the first action resides, and seeks to enforce it in the courts of that state. In such cases, the Supreme Court has repeatedly held that, even though the first judgment creates no *in personam* liability, it conclusively does establish the rights and obligations of corporate stock. What is left open is the question whether the defendant in the second action is a "shareholder" who is therefore liable.⁸⁰

Following the Court of Chancery's reasoning, then, a plaintiff would need only obtain jurisdiction over the corporation, which would be possible in the state in which the tort was committed under typical long-arm tort jurisdiction, and could then pursue the corporation's shareholders without re-litigating the underlying liability. This is exactly the procedure that the Supreme Court approved in *Chandler v. Peketz*, as was discussed above.⁸¹ Although *Chandler* was not technically a class action in the modern sense, because it preceded the enactment of the Federal Rules of Civil Procedure, it was a representative suit, and the Court decided it using the same language that it has used for class actions.

Furthermore, as *Chandler* suggests, whether a judgment against a corporation would be preclusive against its shareholders is not solely dependent on modern class-action procedures. Under an unlimited-liability regime, a judgment of liability against a corporation could be preclusive against its shareholders if they simply had notice of the action that produced that judgment. There are three analogous circumstances that suggest that such

⁷⁹ See *Shutts*, 472 U.S. at 808.

⁸⁰ *Hynson v. Drummond Coal Co., Inc.*, 601 A.2d 570, 577 (Del. Ch. 1991) (Allen, C.) (citing, among other cases, *Chandler v. Peketz*, 297 U.S. 609 (1936)).

⁸¹ See *supra* text accompanying notes 38-45.

preclusion could arise. First, the *Restatement (Second) of Judgments* says that a judgment against a corporation will be preclusive against its shareholders “[i]f a relationship exists between a corporation and . . . stockholder . . . such as that of . . . indemnitee and indemnitor . . . , from which preclusive effects follow under rules governing that relationship.”⁸² The *Restatement* further provides that in an indemnity arrangement, when suit is brought against the indemnitee, and “the indemnitor is given reasonable notice of the action and an opportunity to assume or participate in its defense,” the indemnitor will be estopped from disputing the existence or extent of the liability.⁸³ Second, even if shareholders were not considered indemnitors,⁸⁴ but guarantors, there would still be preclusive effect, though it might be somewhat less. The current tentative draft of the *Restatement (Third) of Suretyship* states that a judgment against a primary obligor creates only a rebuttable presumption of the primary obligor’s liability in a later action against the secondary obligor.⁸⁵ Third, the *Restatement (Second) of Judgments* states that in the related partnership context, a judgment against one partner will be binding on others if the second partner “controlled or participated in controlling the defense of the action, or was given notice of an opportunity to defend the action.”⁸⁶

⁸² RESTATEMENT (SECOND) OF JUDGMENTS § 59(1) (1980).

⁸³ *Id.* § 57. “The requisites of the notice to be given by the indemnitee may be specified by contract or by law or by a combination of both.” *Id.* § 57 cmt. e. It is also worth noting the *Restatement*’s view that a judgment against a corporation will have preclusive effects against its shareholders in the case of “[a] judgment assessing a stockholder . . . of a corporation for payment of an obligation of the corporation . . . if the proceeding leading to the assessment provided adequate notice to him individually or adequate representation of his interests in accordance with §§ 41 and 42.” *Id.* § 59(4) (emphasis added). Section 41 of the *Restatement* sets out the rules for class actions, but the statement just quoted appears to suggest that sufficient notice is an alternative to the class action procedure in the corporate context.

⁸⁴ Shareholders probably *would* be indemnitors under the definition in the *Restatement (Second) of Judgments*, which provides that “[a]n indemnitor is one who is liable for a loss that is initially charged to another, the indemnitee.” *Id.* § 57 cmt. a.

⁸⁵ RESTATEMENT (THIRD) OF SURETYSHIP § 62(2) (Tentative Draft No. 3, 1994).

⁸⁶ RESTATEMENT (SECOND) OF JUDGMENTS § 60(b)(ii) (1980). The *Restatement (Second) of Conflict of Laws* concurs:

A general partner may be said to do business in each state where the partnership does business since this business is carried on in his behalf. If a statute provides that when a partnership does business in the state an action may be maintained against the partners as to causes of action arising from this business, the state may

The point here is not that shareholders in an unlimited-liability regime would necessarily be treated precisely as indemnitors, guarantors, or partners. As is discussed below,⁸⁷ there are good reasons to consider the specific goals of corporate law in determining exactly how to treat shareholders under unlimited liability. Such shareholders would, however, share some of the characteristics of all of the relationships discussed above, and it is thus reasonable, in the absence of more direct information, to look to those analogous relationships. Doing so suggests that personal jurisdiction over every shareholder might not be necessary.

Even if jurisdiction over each shareholder in a defendant class *were* necessary, and *Shutts* does contain some language that suggests that the Supreme Court might treat defendant classes differently from plaintiff classes,⁸⁸

render a valid judgment through its courts against the general partners provided that
it accords them reasonable notice and a reasonable opportunity to be heard.

RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 40 cmt. e (1969).

Professor Alexander attempts to evade the import of these *Restatement* views, citing the comment just quoted and claiming (1) that "[j]urisdiction over the partnership does not . . . automatically confer jurisdiction over the partners individually," Alexander, *supra* note 9, at 401, and (2) that "[a] judgment against the partnership in the firm name is not automatically enforceable against the partners," *id.* at 401 n.68. It is important to note that neither of her statements denies that a judgment against one partner is binding on other partners with notice of the action, the point of both of the *Restatement* quotations. That rule makes her statements of very limited importance. As for the first, if judgment over one partner can be made binding over the others simply by providing them with notice of the action, there is no need to obtain jurisdiction over them. (In any event, the first sentence of the *Restatement* quotation above suggests that there would be no constitutional difficulty with a state's assertion of jurisdiction over the partners on the basis of the partnership's business in the forum state.) Similar considerations apply to Professor Alexander's second statement. If one can bind all partners in an action against one, a sensible plaintiff would sue individual partners, even in states in which the partnership could be sued in the firm name.

⁸⁷ See *infra* part V.B.2.

⁸⁸ As described in the text accompanying notes 76-79 *supra*, the Court in *Shutts* focused more on the differences between individual and class defendants, rather than on the differences between defendants and plaintiffs. Nevertheless, the Court also said that "[a]n out-of-state defendant summoned by a plaintiff is faced with the full powers of the forum State to render judgment *against* it." *Shutts*, 472 U.S. at 808. Although other of the Court's statements suggest that it was primarily concerned about the possibility that a defendant could be subject to a default judgment, see *id.* at 809 ("In sharp contrast to the predicament of a defendant haled into an out-of-state forum, the plaintiffs in this suit were not haled anywhere to defend themselves upon pain of a default judgment."), which would not be an issue in a class action, where the defendants would be represented by a class representative, the implications of *Shutts* for defendant class actions are uncertain.

it still seems likely that proceeding by means of a class action would satisfy the fairness element of the jurisdictional test. The fairness requirement, as discussed above,⁸⁹ seeks to avoid placing unreasonable burdens on defendants, and *Shutts* observes that the burdens on class members are considerably less than those on individual litigants.⁹⁰ Thus, a tort creditor, by proceeding against shareholders as a class, could probably avoid imposing on the shareholders any unreasonable burden in defending themselves. The creditor could then establish jurisdiction by showing that the federalism element was met, *i.e.*, that the shareholders had purposefully availed themselves of activities in the forum state.⁹¹ As the next section demonstrates, such a showing would be quite possible.

C. Substantive Liability as a Basis for Jurisdiction

Professor Alexander overstates her case when she says that “[a] defendant’s potential liability is not a factor in determining whether a court has personal jurisdiction over her.”⁹² Liability in itself is not sufficient to create jurisdiction, but a defendant’s knowing assumption of potential liability in a particular jurisdiction establishes a relationship with that jurisdiction that may be sufficient to do so. Professor Alexander overlooks this possibility, perhaps because she looks only at circumstances in which a liability relationship derives at least in part from one party’s control over another; where liability is based on control, it is not surprising that, as Professor Alexander concludes, it is “the out-of-state defendant’s control over in-state activities [that] explains why there is personal jurisdiction over him.”⁹³ However, if one looks further, to cases in which liability is not based on control, it is clear that jurisdiction is possible there as well. The discussion below shows, first, that little information regarding jurisdiction can be derived from fact situations that also present control issues, and, second, that circumstances in which liability is present and control absent also permit jurisdiction.

1. The Limited Relevance of Control: Corporate Veil-Piercing

⁸⁹ See *supra* text accompanying notes 67–69.

⁹⁰ See *Shutts*, 472 U.S. at 808–09.

⁹¹ See *supra* text accompanying notes 70–73.

⁹² Alexander, *supra* note 9, at 394 (footnote omitted). Later in her article, Professor Alexander states the law more accurately: “Substantive liability does not automatically confer personal jurisdiction.” *Id.* at 400.

⁹³ *Id.* at 401.

In seeking cases analogous to unlimited shareholder liability, it seems at first glance that the most logical choice would be to look, as Professor Alexander does,⁹⁴ at cases involving corporate veil-piercing. Piercing the corporate veil does, after all, impose liability on the corporate shareholders. The problem with this approach, however, is that the background rule in veil-piercing cases is one of limited liability, so that some special circumstance must be present to pierce the veil. Most veil-piercing cases, as Professor Alexander points out,⁹⁵ apply some form of an "alter ego" or "instrumentality" theory of veil-piercing, under both of which the test is whether the corporation is truly an independent entity or is merely a tool controlled by its shareholder(s).⁹⁶ Because shareholder liability exists only if this control-based test is met, and jurisdiction over the shareholders becomes an important issue only if liability is present, jurisdiction in these circumstances will be present only if the shareholders control the corporation, just as Professor Alexander argues.⁹⁷

The problem with this argument, though, is that it conflates the liability and jurisdictional inquiries.⁹⁸ Because liability can itself be a factor in

⁹⁴ See *id.* at 401 & n.67. Professor Alexander takes this approach in part because Professors Hansmann and Kraakman do. See Hansmann & Kraakman, *supra* note 1, at 1922 & n.110.

⁹⁵ See Alexander, *supra* note 9, at 401.

⁹⁶ See generally STEPHEN B. PRESSER, *PIERCING THE CORPORATE VEIL* § 1.03(4) (1991).

⁹⁷ Alexander, *supra* note 9, at 401. Actually, this statement of the situation is not entirely accurate, because some courts analyze the jurisdictional issue independently of the liability one. See, e.g., *Dakota Indus., Inc. v. Ever Best Ltd.*, 28 F.3d 910, 915 (8th Cir. 1994) ("A determination to pierce the corporate veil does not necessarily answer the question of a court's jurisdiction over the individuals behind the veil."); *United Elec., Radio & Mach. Workers of Am. v. 163 Pleasant St. Corp.*, 960 F.2d 1080, 1084-85 (1st Cir. 1992) ("The parties have focused singlemindedly on the strength of [the subsidiary's] corporate veil as the linchpin of the jurisdictional inquiry. We deem it advisable to take a step backward. While we are cognizant that a certain symbiosis exists between the jurisdictional inquiry and the corporate inquiry, the inquiries are separate and unequivalent."); *but see* *Rice v. Oriental Fireworks Co.*, 707 P.2d 1250, 1255 (Or. Ct. App. 1985) ("In deciding whether [a shareholder] should be required to appear and answer personally, the appropriate criteria are the same as those applied for the purpose of imposing personal liability."). The fundamental point made in the text is still valid, though—there is no reason to think that the jurisdictional test when shareholder liability is normally limited would be the same one applied if liability were normally unlimited. Breaking down a wall does not necessarily give the same result as if the wall never existed.

⁹⁸ That is not to say that the veil-piercing cases treat the liability and jurisdictional inquiries the same. In fact, many of the cases treat them differently. See *supra* note 97. The

determining whether jurisdiction is present, looking to cases in which liability is normally absent, so that some special threshold must be passed to create liability, is not enlightening. Put another way, there is no reason to expect that the jurisdictional test that would apply if shareholder liability were unlimited would be the same as the one applied currently, when liability is normally limited.⁹⁹ This will become more clear in the discussion below,¹⁰⁰ where it is shown that jurisdiction can depend on a defendant's knowledge and acceptance of substantive liability in a forum state. A shareholder of a limited-liability corporation has no expectation of liability for the debts of his corporation

point is that the jurisdictional question is likely to be treated differently in a case in which liability is also in question than in one in which liability is certain.

⁹⁹ Lea Brilmayer and Kathleen Paisley make a similar, but more general, point in their article on the interrelationship of jurisdictional issues and substantive legal relationships:

The substantive relations that enter into due process calculations are primarily a matter of the law that creates the cause of action, usually state law. [T]here are no a priori or empirical theories that authoritatively connect local acts of one individual to another individual outside the state or that categorize a series of activities as caused by a single abstract entity such as a corporation or a conspiracy. Only normative theories perform that function in law, and such theories are created by the states and not by the limits contained in the federal constitution.

Lea Brilmayer & Kathleen Paisley, *Personal Jurisdiction and Substantive Legal Relations: Corporations, Conspiracies, and Agency*, 74 CAL. L. REV. 1, 25 (1986).

The Supreme Court made a somewhat analogous point in *Cannon Manufacturing Co. v. Cudahy Packing Co.*, 267 U.S. 330 (1925). It is sometimes suggested that *Cannon* rules out the possibility of jurisdiction derived from a parent-subsidiary relationship, but that is not so, or at least would not be so in an unlimited-liability regime. In *Cannon* the plaintiff asserted jurisdiction over a Maine corporation, but had served process on the defendant's Alabama subsidiary, apparently in North Carolina, where the action was brought. Whether the Court viewed the issue as a constitutional or statutory one is not clear, but it described the question as "simply whether the corporate separation carefully maintained *must* be ignored in determining the existence of jurisdiction." *Id.* at 336 (emphasis added). It concluded that it did not, and affirmed the dismissal of the action. The Court made very clear, though, that its decision was made only on a formal basis, and that substantive liability, had it existed, might have produced a different result: "There is here no attempt to hold the defendant liable for an act or omission of its subsidiary or to enforce as against the latter a liability of the defendant. Hence, cases concerning substantive rights . . . have no application." *Id.* at 337 (citing *Hart Steel Co. v. Railroad Supply Co.*, 244 U.S. 294 (1917); *Chicago, M. & St. P. Ry. Co. v. Minneapolis Civic Ass'n*, 247 U.S. 490 (1918); *Gulf Oil Corp. v. Lewellyn*, 248 U.S. 71 (1918); and *United States v. Lehigh Valley R.R. Co.*, 254 U.S. 255 (1920)).

¹⁰⁰ See *infra* part III.C.2.

(regardless of whether, through veil-piercing, such liability is imposed), so such a shareholder has no reason to expect to be haled into court where the corporation does business. A shareholder of an unlimited-liability corporation, in contrast, would know of his potential liability for the debts of the corporation, and hence would know of his connection with the states in which the corporation does business.

2. *The Sufficiency of Liability*

There are several relationships in which jurisdiction is sought over one party based on that party's liability for the debt of another. The relationship of that kind that seems most logical to consider here is partnership. But partnership is not a useful analogy, for two reasons. First, individuals in a partnership are formally agents of their partners,¹⁰¹ which makes it difficult to draw conclusions from the partnership's jurisdictional treatment to the proper treatment in a liability-without-agency relationship. Second, because of this agency relationship, a judgment against one partner is generally binding against others who had notice of the action, as in a defendant class action;¹⁰² hence, personal jurisdiction over all of the partners is not necessary.¹⁰³ The discussion below concentrates specifically on two relationships in which jurisdiction has been found purely based on the acceptance of liability: guaranties and insurance. Neither of these relationships involves any element of control, so they provide a closer analogy to unlimited shareholder liability than do the veil-piercing or partnership situations.

¹⁰¹ The Uniform Partnership Act states that each partner is the agent of his or her partners for the purpose of the partnership business. UNIFORM PARTNERSHIP ACT § 9(1) (1914).

¹⁰² See *supra* note 86 and accompanying text.

¹⁰³ That is not to say that it is unavailable, though. See, e.g., *In re Alexander Grant & Co. Litigation*, 110 F.R.D. 528, 532 (S.D. Fla. 1986) (observing that in an earlier proceeding some of the 470 defendant partners had sought to have the action dismissed for lack of personal jurisdiction, but that the court had concluded that "as Grant elected to conduct itself as a partnership in Florida, the individual partners were subject to personal jurisdiction in Florida."); *Schroeder v. Raich*, 278 N.W.2d 871, 875 (Wis. 1979) ("Raich, a partner, may be said to be doing business in Wisconsin because the partnership does business in this state and partnership business is carried on in behalf of each partner.") (citing RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 40 cmt. e (1969)); see also *supra* note 86 and accompanying text.

a. *Guaranties*

A guarantor, one who “contracts to fulfill an obligation upon the default of the principal obligor,”¹⁰⁴ is a logical choice for comparison with a shareholder subject to unlimited liability. Both stand in positions of secondary liability, the guarantor to his principal obligor and the shareholder to the unlimited-liability corporation. In some cases, in fact, the two circumstances collapse into one, as when shareholders of close corporations guarantee the loans of their corporations.¹⁰⁵ To the extent that the two circumstances differ, it seems that the argument for jurisdiction is even stronger for an unlimited-liability shareholder than for a guarantor, because a shareholder receives a share of the profits of her corporation in the forum state, but a guarantor typically does not.¹⁰⁶

Courts have generally been quite willing to find jurisdiction over non-resident guarantors, using rationales that apply equally well to unlimited-liability shareholders. The courts appear to require either of two related conditions to find that a guarantor has “purposefully availed” itself of the law of the forum state so as to establish jurisdiction. The first, which applies in those jurisdictions that look primarily to the place designated for payment of the guaranty, requires that the guaranty or the business to which it relates have some significant connection with the forum state. The second, which applies in jurisdictions that look more broadly at the entire guaranty transaction, requires that the guarantor know that the obligation that he guarantees has connections or effects in the forum state. Each of these approaches is discussed below.

The place-of-payment approach is used in the Second Circuit,¹⁰⁷ and the requirement that the business of the guaranty be connected to the forum is demonstrated in a recent case from that court, *A.I. Trade Finance, Inc. v. Petra*

¹⁰⁴ RESTATEMENT (THIRD) OF SURETYSHIP § 1 cmt. c (Tentative Draft No. 1, 1992).

¹⁰⁵ Professor Leebron has suggested that the frequent requirement of contract creditors for shareholder guarantees is itself a justification for using unlimited shareholder liability to provide the same advantage to tort creditors. See Leebron, *supra* note 1, at 1630–32.

¹⁰⁶ See *infra* note 112.

¹⁰⁷ See, e.g., *A.I. Trade Finance, Inc. v. Petra Bank*, 989 F.2d 76, 82 (2d Cir. 1993) (“[T]he guaranteeing of the Notes by [the non-resident defendant], including the promise to make payment to a New York-based company in New York, constitute[d] ‘some act by which the defendant purposefully avail[ed] itself of the privilege of conducting activities with the forum State, thus invoking the benefits and the protection of its laws.’”) (quoting *Burger King Corp. v. Rudzewicz*, 471 U.S. 462, 475 (1985) (quoting *Hanson v. Denckla*, 357 U.S. 235, 253 (1958))).

Bank.¹⁰⁸ In *A.I. Trade*, the defendant guarantor argued, relying on an earlier Second Circuit case, that the choice of New York as the place of payment for its guaranty was an "unbargained-for accommodation" and did not constitute a purposeful availment of New York laws.¹⁰⁹ However, in the earlier case the court had relied on the fact that "neither the business of the syndicate nor of the note had a substantial connection" with the forum state,¹¹⁰ and the court rejected a similar argument in *A.I. Trade*, observing that there were good reasons for the guarantee to be payable in a financial capital, and that the designation of the place of payment as New York therefore "seem[ed] to be the opposite of accidental."¹¹¹ This test would also be met in the unlimited-liability situation. To draw the analogy, recall that the issue of unlimited liability would arise only if a corporation committed a tort in the forum state. In those circumstances, the business that the shareholder "guarantees," *i.e.*, the business of the corporation, would have a substantial connection with the forum state.¹¹²

¹⁰⁸ 989 F.2d 76 (2d Cir. 1993).

¹⁰⁹ *Id.* at 82 (citing *Savin v. Ramer*, 898 F.2d 304 (2d Cir. 1990)). *Savin* involved a simple note, not a guarantee. The court in *Savin* rejected jurisdiction on statutory grounds, but went on to discuss the due process issues in dicta, indicating that a non-resident's designation of a place of payment as "an unbargained-for convenience" for the benefit of the payee would not constitute the purposeful availment required by due process. *Savin*, 898 F.2d at 307.

¹¹⁰ *Savin*, 898 F.2d at 307 (citing *World-Wide Volkswagen Corp. v. Woodson*, 444 U.S. 286, 299 (1980)).

¹¹¹ *A.I. Trade Finance*, 989 F.2d at 82-83. The court quoted the following comment from the Supreme Court: "By issuing negotiable debt instruments denominated in U.S. dollars and payable in New York and by appointing a financial agent in that city, [the defendant] 'purposefully avail[ed] itself of the privilege of conducting activities within the [United States].'" *Id.* at 83 (quoting *Republic of Argentina v. Weltover, Inc.*, 504 U.S. 607, 619-20 (1992) (citations omitted and "the defendant" interpolated by Second Circuit)). In *Weltover*, Argentina, the defendant, was the primary obligor, not a guarantor. *Weltover*, 504 U.S. at 609-10.

¹¹² This conclusion is even more clear in some other cases that use the same basic connection-with-the-forum-state approach, but also rely on a guarantor's economic interest in the forum-state connection. *See, e.g.*, *National Can Corp. v. K Beverage Co.*, 674 F.2d 1134, 1138 (6th Cir. 1982) ("Signing a personal guaranty for a Kentucky business in which one has an economic interest is the sort of 'conduct and connection with the form State' that makes it reasonable to 'anticipate being haled into court there' when the underlying contract is breached.") (citing *World-Wide Volkswagen*, 444 U.S. at 297); *Royal Bank of Canada v. Trentham Corp.*, 491 F. Supp. 404, 408 (S.D. Tex. 1980) (upholding constitutionality of jurisdiction where "[i]t was in Defendant's business self-interests to establish [forum-state corporation] as a potential customer for its engineering know-how" and "[t]o that end,

The second approach to jurisdictional issues in the guaranty context rejects the place of payment as the predicate for jurisdiction and looks to the broader range of activities in which the nonresident guarantor engaged.¹¹³ These cases typically find jurisdiction “so long as [the guarantor’s] conduct is such that he should foresee that his actions would have effects in [the forum] state.”¹¹⁴ Although such an “effects” test might seem to abandon the “purposeful availment” aspect of the due process test, in fact the test, like the Second Circuit’s, is usually applied in such a way as to require some other economic relationship with a forum state resident.¹¹⁵ In light of that requirement, the

Defendant agreed to guarantee loans made by Plaintiff to the [forum] corporation”), *vacated on other grounds*, 665 F.2d 515 (5th Cir. 1981).

¹¹³ See, e.g., *Venetian Salami Co. v. Parthenais*, 554 So. 2d 499, 503 (Fla. 1989) (“[W]e do not believe that the mere failure to pay money in Florida, standing alone, would suffice to obtain jurisdiction over a nonresident defendant.”) (footnote and citation omitted); *Keelean v. Central Bank of the South*, 544 So. 2d 153, 157 (Ala. 1989) (“Or does the mere signing of a guaranty, out of state, for performance in state, present the sufficient contact with the [forum state] necessary for *in personam* jurisdiction? . . . In determining whether the nonresident guarantors possessed sufficient contact with the [forum state] for a trial court to obtain *in personam* jurisdiction, it is necessary for us to examine all the relevant facts of the case.”) (citation omitted).

¹¹⁴ *Millette v. O’Neal Steel, Inc.*, 613 So. 2d 1225, 1228 (Ala. 1992); see also *Keelean*, 544 So. 2d at 157. The Alabama courts rely for this reading of the due process requirements on *Calder v. Jones*, 465 U.S. 783 (1984). *Calder* was a challenge by a writer and editor for a Florida-based publication who wrote and edited an allegedly defamatory article about a California resident to jurisdiction in California. The Court held that because the article “concerned the California activities of a California resident,” “impugned the professionalism of an entertainer whose television career was centered in California,” “was drawn from California sources,” and caused the “brunt” of its harm in California, that “California [was] the focal point both of the story and of the harm suffered. *Id.* at 788–89 (footnote omitted). Hence, the Court said that “[j]urisdiction over petitioners [was] therefore proper in California based on the ‘effects’ of their Florida conduct in California.” *Id.* at 789 (citing *World-Wide Volkswagen*, 444 U.S. at 297–98; RESTATEMENT (SECOND) OF CONFLICT OF LAW § 37 (1969)).

¹¹⁵ See, e.g., *Millette*, 613 So. 2d at 1228 (forum state had jurisdiction over nonresident owners of corporation who guaranteed corporate line of credit from corporation whose headquarters and principal place of business was in forum state and guarantors traveled to forum state to negotiate modification of credit agreement); *Venetian Salami Co.*, 554 So. 2d at 503 (affidavits alleging that nonresident contacted resident in forum state to engage his services in investing delinquent debt, in part in forum state, and payment would be made in forum state, sufficient to preclude summary judgment); *Jones v. Directors Guild of America, Inc.*, 584 So. 2d 1057, 1059–60 (Fla. Dist. Ct. App. 1991) (affidavit alleging that nonresident was executive producer of motion picture and guaranteed payments to directors hired by movie’s production company sufficient to preclude summary judgment,

distinctive feature of the "effects" test seems to be a requirement that the guarantor know that the guarantee relates to business in the forum state. As one court said, "[i]t appears that the [guarantors] knew that they were guaranteeing the debts of [a non-forum-state corporation] and knew that [the non-forum-state corporation] was purchasing steel on credit from a corporation located in [the forum state]."¹¹⁶ Thus, under this rationale, jurisdiction could be found over a shareholder of a non-forum-state corporation who knew that the corporation was doing business, and thus could incur a tort judgment, in the forum state, and also knew that the state's law imposed unlimited liability. The requirement of such knowledge goes beyond a mere economic interest in the forum-state activity, but is still likely to be met by shareholders, as will be shown below.¹¹⁷

b. Insurance

Insurance contracts present another important analogy to unlimited liability. In one sense, insurance is not as good an analogy to shareholder liability as is the guaranty relationship, because insurers are primarily, rather than secondarily, liable, and because one aspect of an insurance contract is the duty to defend. In another way, though, insurance is a better analogy, because a liability insurer can be required to pay the amount of tort judgments, whereas guaranties typically apply only to contractual arrangements. In any event, all three relationships—shareholder liability, guaranties, and insurance—present an issue of indirect liability of one party for an obligation of another, and it is that issue on which the minimum-contacts question turns.¹¹⁸

where there is factual question as to nonresident guarantor's connection with production company and place where movie was being produced).

¹¹⁶ *Millette*, 613 So. 2d at 1228; see also *Venetian Salam Co.*, 554 So. 2d at 501 ("It is these factors—prior negotiations and contemplated future consequences, along with the terms of the contract and the parties' actual course of dealing—that must be evaluated in determining whether the defendant purposefully established minimum contacts within the forum.") (quoting *Burger King Corp. v. Rudzewicz*, 471 U.S. 462, 479 (1985)).

¹¹⁷ See *infra* part IV.

¹¹⁸ It is important to note that the analogy being drawn in this section is one between an unlimited-liability shareholder and an insurer. There is, therefore, no question of *Seider* jurisdiction, see *Seider v. Roth*, 216 N.E.2d 312 (N.Y. 1966), in which a plaintiff seeks to obtain jurisdiction over an absent defendant by attaching the defendant's insurer's obligation to indemnify and defend. In other words, the argument is not that a plaintiff could get jurisdiction over a shareholder through the shareholder's insurer; the argument is that the shareholder is an insurer. See Robert B. Thompson, *Unpacking Limited Liability: Direct and Vicarious Liability of Corporate Participants for Torts of the Enterprise*, 47 VAND.

States generally require insurers to register and to appoint the state insurance commissioner as their agent for service of process.¹¹⁹ Therefore, jurisdictional issues usually do not play a large part in insurance litigation. However, occasionally an insurer that is not registered in a state will sell insurance contracts there, and may then refuse to appear if a claim is made. To meet this difficulty, the National Association of Insurance Commissioners has advanced the Unauthorized Insurers Process Act.¹²⁰ The Act provides that any "unauthorized foreign or alien insurer" will be deemed to have appointed the state insurance commissioner its agent for service of process if it issues insurance contracts "to residents of this state or to corporations authorized to

L.REV. 1, 21 (1994) ("One can view unlimited liability as a method by which shareholders provide insurance to tort victims of the enterprise.").

This distinction is important because Professor Alexander says that "Professors Hansmann and Kraakman suggest that the existence of insurance might provide a way to avoid the jurisdictional problems associated with their proposal." Alexander, *supra* note 9, at 404 (footnote omitted). She suggests that in making this claim Hansmann and Kraakman rely on *Seider* jurisdiction, which was rejected by the Supreme Court in *Rush v. Savchuk*, 444 U.S. 320 (1980). Alexander, *supra* note 9, at 404-05. That is not Hansmann and Kraakman's point, though. Hansmann and Kraakman say only that "insurance could greatly facilitate collection against small shareholders . . . by centralizing the collection effort against a handful of insurers rather than numerous shareholders." Hansmann & Kraakman, *supra* note 1, at 1901. In other words, their point is not related to jurisdiction, but simply to the practicalities of litigation.

Hence, nothing in *Rush* presents a problem here. In *Rush*, a Minnesota resident sought to obtain jurisdiction over the insurance policy of an Indiana resident with no contacts in Minnesota by garnishing the obligation of the defendant's insurer, which did business in Minnesota, to defend and indemnify. *Rush*, 444 U.S. at 322-25. The Court rejected the attempt, concluding that "it cannot be said that the *defendant* engaged in any purposeful activity related to the forum that would make the exercise of jurisdiction fair, just, or reasonable, merely because his insurer does business there." *Id.* at 329 (citations omitted). The analogy in the unlimited-liability context, in light of unlimited-liability shareholders' role as insurers in the analogy, would be an attempt by a plaintiff injured by a corporate tort to obtain jurisdiction over the corporation in a state in which the corporation had no contacts but one of its shareholders did. That is not the jurisdictional problem that unlimited liability presents.

¹¹⁹ See, e.g., N.Y. INS. LAW §1212 (McKinney 1985).

¹²⁰ UNAUTHORIZED INSURERS PROCESS ACT (National Association of Insurance Commissioners 1991). The Act's purpose is "to subject certain insurers to the jurisdiction of courts of this state in suits by or on behalf of insureds or beneficiaries under insurance contracts." *Id.* § 1.

do business in the state.”¹²¹ This or similar legislation has been adopted by forty-one states.¹²²

The Act's assertion of jurisdiction over an insurer who issues a contract to a corporation doing business in the forum state, which is analogous to a similar assertion over an unlimited-liability shareholder, has been upheld by the courts.¹²³ In a recent Second Circuit case, *Armada Supply Inc. v. Wright*,¹²⁴ the insured was a Texas corporation that contracted with a Brazilian oil company to purchase oil to be delivered in New York. The oil was insured by the Brazilian company for its shipment from Rio de Janeiro to New York, and during the trip it became contaminated. The district court awarded a judgment to the Texas corporation against the Brazilian insurer, which then argued on appeal that the district court did not have personal jurisdiction over it. The court of appeals rejected the jurisdictional argument. It quoted New York's version of the act and noted that the insurer had, at the request of the Brazilian company, delivered a certificate of insurance to the Texas corporation in New

¹²¹ *Id.* § 2(A).

¹²² *Id.* at 850-5 to 850-8 (listing the states adopting such provisions). Although the corporate aspect of the Act, the subject of the text discussion, has not been considered by the Supreme Court, the Act more generally has twice come before the Court. In each case the Court found jurisdiction, but in each the insurer's contacts with the forum state were greater than those of a shareholder of a corporation doing business there. In *McGee v. International Life Ins. Co.*, 355 U.S. 220 (1957), the Court said that “[i]t is sufficient for purposes of due process that the suit was based on a contract which had substantial connection with that State.” *Id.* at 223 (citations omitted). In *McGee*, however, the contract had been delivered to the insured in California and the insured had mailed premiums from there. *Id.* at 221-22. Similarly, in *Travelers Health Ass'n v. Virginia*, 339 U.S. 643 (1950), the Court found no jurisdictional problem in the state of Virginia's service of process on an out-of-state insurer, citing its earlier recognition that “a state has a legitimate interest in all insurance policies protecting its residents against risks.” *Id.* at 647 (citing *Osborn v. Ozlin*, 310 U.S. 53, 62 (1940)). The insurer, however, had mailed applications to potential insureds in Virginia, who then, if they chose, returned the applications and a fee to the insurer in Nebraska. *Id.* at 645-46.

¹²³ The provision has encountered jurisdictional difficulties only when the terms of the statute were not met. *See, e.g.*, *Ford v. Unity Hosp.*, 299 N.E.2d 659 (N.Y. 1973); *but see Hilbun v. California-Western States Life Ins. Co.*, 210 So. 2d 307, 309-10 (Miss. 1968) (rejecting jurisdiction over an insurer of an employer with employee in the forum state on the ground that act providing for service of process on insurer stated that its concern was for residents who “hold policies of insurance issued or delivered them in this state” (quoting Miss. CODE 1942 § 5705-11 (Supp. 1966) (emphasis added by court)). Although the failure of the facts of a case to satisfy the terms of the statute obviates the need for a due process inquiry, many courts nevertheless take a belt-and-suspenders approach.

¹²⁴ 858 F.2d 842 (2d Cir. 1988).

York.¹²⁵ This, the court said, was sufficient to satisfy the requirements of the statute, in that the certificate “was issued directly to a company authorized to do business in New York.”¹²⁶ The court did not consider the due process question in any detail, but it did say that “no constitutional barriers existed to the district court’s exercise of personal jurisdiction over [the insurer] on these facts.”¹²⁷

Significantly, *Armada Supply* rejected the insurer’s argument that it should not be subject to jurisdiction in light of *Ringers’ Dutchocs, Inc. v. S.S. S.L. 180*.¹²⁸ In *Ringers’ Dutchocs*, the certificates of insurance, rather than being delivered directly to a corporation authorized to do business in New York, were issued to a German shipper made out to “the bearer,” and the shipper delivered the certificate to the plaintiff, which was the receiver of the shipped good, in New York.¹²⁹ The Second Circuit made the following comments:

[W]e are of the view that although the insured “bearer” proved to be a corporation authorized to do business in New York, that fact nevertheless was not sufficient to confer jurisdiction pursuant to [the act] because it was by no means certain, nor even likely, that the insured purchaser of the goods shipped to a New York warehouse would in fact be a corporation authorized to do business in New York. Thus, [the insurer’s] conduct did not comport with the conceptual underpinnings of long-arm jurisdiction—an implied consent to the constructive agency through the voluntary and, therefore, knowing act of insuring a corporation authorized to do business in New York.¹³⁰

This emphasis on the insurer’s knowledge of the implications of its assumption of liability in the forum state echoes the same concern in the guarantor cases.¹³¹ It is a requirement that would be met by shareholders in an

¹²⁵ *Id.* at 848.

¹²⁶ *Id.*

¹²⁷ *Id.* at 849 (citing *Burger King Corp. v. Rudzewicz*, 471 U.S. 462 (1985); *McGee v. International Life Ins. Co.*, 355 U.S. 220 (1957); *Travelers Health Ass’n v. Virginia*, 339 U.S. 643 (1950)). *McGee* and *Travelers Health* are discussed in note 122 *supra*.

¹²⁸ 494 F.2d 678 (2d Cir. 1974).

¹²⁹ *Id.* at 679; see also *Armada Supply*, 858 F.2d at 848.

¹³⁰ *Ringers’ Dutchocs, Inc.*, 494 F.2d at 679.

¹³¹ See *supra* part III.C.2.a. Other courts have also followed this basic knowledge-based approach. For example, in a case in which an Indiana corporation insured several corporations that were not New York corporations but had offices and employees in New York, the Civil Court of the City of New York said that the defendant insurer was “chargeable with knowledge that its corporate insureds intended to provide this coverage under the group policies to New York residents and that the New York residents were the covered beneficiaries of these contracts.” *Comprehensive Foot Care Group v. Lincoln Nat’l*

unlimited-liability regime, as is discussed in the next part of this article. It is also a requirement that is entirely consistent with Supreme Court jurisdictional decisions, as is discussed in the next section.

D. Liability, Purposeful Availment, and the Supreme Court

The two requirements for liability-based jurisdiction discussed in the last section, economic benefit from the arrangement that creates the liability¹³² and knowledge of the potential forum-related effects of that arrangement,¹³³ are entirely consistent with Supreme Court precedent in this area, at least if *both* are present.¹³⁴ Because the Court has not decided a case that presented a close factual analogy to liability-based jurisdiction, it has not discussed the jurisdictional issues in precisely these same terms. Nevertheless, in some of the Court's decisions,¹³⁵ most particularly *Burger King Corp. v. Rudzewicz*,¹³⁶ the circumstances are similar enough so that the Court does rely on some of the same basic concepts. *Burger King* is mentioned only briefly by Professor Alexander, who devotes most of her attention to two other cases, *Shaffer v.*

Life, 517 N.Y.S.2d 652, 655 (N.Y. Civ. Ct. 1987). The court suggested that an insurer would be subject to jurisdiction whenever it had issued policies to corporations that themselves had minimum contacts with the forum state. *Id.* Similarly, in a case arising under a different statute, one that referred only to the "transacting of business" in the state, a federal district court held that the issuance of a liability insurance policy to the owner of a boat that, by the terms of the policy, was specified to be operating in Louisiana, was sufficient to subject the insurer to jurisdiction in Louisiana. *Humble Oil & Refining Co. v. M/V John E. Coon*, 207 F. Supp. 45, 48 (E.D. La. 1962).

¹³² See *supra* text accompanying notes 107-12.

¹³³ See *supra* text accompanying notes 113-17 and 123-31.

¹³⁴ It is not clear whether, as some of the lower court cases discussed in the last section suggest, either alone is sufficient. However, because the first of the requirements, economic benefit from the liability relationship, is always present in the shareholder context, it is enough that the second requirement, knowledge of potential effects in the forum state, is also factually present and that the two requirements together are legally sufficient. The factual presence of the second requirement is discussed *infra* part IV.

¹³⁵ Although this section concentrates on *Burger King*, the Court's cases considering the Unauthorized Insurers Process Act also support the conclusion reached here. The insurance cases are described briefly *supra* note 122.

¹³⁶ 471 U.S. 462 (1985).

*Heitner*¹³⁷ and *World-Wide Volkswagen Corp. v. Woodson*,¹³⁸ which present much less close factual analogies.¹³⁹

In *Burger King*, as in the shareholder situation, the connection of the defendant to the forum state was not strong, but was known and accepted. The defendant, Rudzewicz, was a Burger King franchisee; Burger King was based in Florida, where it brought suit, but Rudzewicz's dealings with the company had been through its Michigan office. Nevertheless, the Supreme Court had no difficulty in deciding that Rudzewicz's contacts with Florida were sufficient to support jurisdiction. It described his dealings with Burger King as a "voluntary

¹³⁷ 433 U.S. 186 (1977).

¹³⁸ 444 U.S. 286 (1980).

¹³⁹ *World-Wide Volkswagen* is discussed in the text of this section, but *Shaffer* is not sufficiently analogous to make extended discussion necessary. The case was based on a "sequestration" procedure of Delaware law which allowed Delaware to obtain jurisdiction over a suit by "sequestering" any of the defendant's property in the state. In *Shaffer*, the plaintiff brought suit in Delaware against the officers and directors of a Delaware corporation, and asserted jurisdiction based on the defendants' ownership of stock in the corporation, relying on another Delaware law that made the state the situs of stock of a corporation incorporated there. The Supreme Court pointed out that this sort of *quasi in rem* jurisdiction, though purportedly over property only, also governs the interests of persons in the property. *Shaffer*, 433 U.S. at 207 (citing RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 56, Introductory Note (1969)). The Court noted that there was only a coincidental relationship between the grounds for liability and the presence of the defendants' property in Delaware. *Id.* at 213-15. The court also pointed out that "as Heitner's failure to secure jurisdiction over seven of the defendants named in his complaint demonstrates, there is no necessary relationship between holding a position as a corporate fiduciary and owning stock or other interests in the corporation." *Id.* at 214 (footnote omitted).

Professor Alexander observes that the Court in *Shaffer* "held that mere ownership of shares does not satisfy the minimum contacts test, even when the corporation is incorporated in the state." Alexander, *supra* note 9, at 396 (footnote omitted). But "mere" ownership of shares is not at issue with unlimited liability, and the Court in *Shaffer* said that the ownership of property could be relevant in determining whether jurisdiction was proper. See *Shaffer*, 433 U.S. at 207-08. Most relevant here, the Court said that "[t]he presence of property may . . . favor jurisdiction in cases, such as suits for injury suffered on the land of an absentee owner, where the defendant's ownership of the property is conceded but the cause of action is otherwise related to rights and duties growing out of that ownership." *Id.* at 208 (footnote omitted). Obviously, shareholder liability is *directly* "related to rights and duties growing out of the ownership" of shares. As Professors Hansmann and Kraakman state, "*Shaffer* is fully consistent with basing jurisdiction on stock ownership when, as under [their] proposed pro rata liability rule, stock ownership is the very predicate of substantive tort liability, and the amount of stock owned determines the damages for which the defendant is liable." Henry Hansmann & Reimer Kraakman, *A Procedural Focus on Unlimited Shareholder Liability*, 106 HARV. L. REV. 446, 457 (1992) (footnote omitted).

acceptance of the long-term and exacting regulation of his business from Burger King's Miami headquarters."¹⁴⁰ The Court's view of the arrangement was not changed by the fact that Rudzewicz dealt almost exclusively with Burger King's Michigan office, because, the Court said, "Rudzewicz most certainly knew that he was affiliating himself with an enterprise based primarily in Florida."¹⁴¹ The Court held this view despite the fact that Rudzewicz's only dealings with Florida were indirect.¹⁴²

A shareholder has a similar relationship with the citizens of a state in which her corporation is doing business. If the shareholder is aware that a corporation in which she owns stock is doing business in an unlimited liability state, her purchase or continued ownership of the stock is, like Rudzewicz's entry into his franchise agreement, a "voluntary acceptance" of her connection with that state and its residents. Furthermore, the shareholder, like Rudzewicz, benefits from her connection with the forum state. This sort of benefit was also relied on by the Court in *Burger King*, which said that

where individuals 'purposefully derive benefit' from their interstate activities, it may well be unfair to allow them to escape having to account in other States for consequences that arise proximately from such activities; the Due Process Clause may not readily be wielded as a territorial shield to avoid interstate obligations that have been voluntarily assumed.¹⁴³

In place of *Burger King*, Professor Alexander relies on *World-Wide Volkswagen*, an earlier case. She says that *World-Wide Volkswagen* "foreclosed the argument that jurisdiction could constitutionally be based *solely* on the fact that out-of-state shareholders derive economic benefit from the corporation's in-state activities."¹⁴⁴ The use of the word "solely" perhaps makes this statement technically true, but it is incomplete. It is true that the Court in *World-Wide Volkswagen* said that "financial benefits accruing to the defendant from a collateral relation to the forum State will not support jurisdiction if they do not

¹⁴⁰ *Burger King*, 471 U.S. at 480.

¹⁴¹ *Id.*

¹⁴² See *id.* at 481 (noting that when Rudzewicz had disagreements with Burger King, he "learned that the Michigan office was powerless to resolve their disputes and could only channel their communications to Miami").

¹⁴³ *Id.* at 473-74 (citation omitted). See also Leebron, *supra* note 1, at 1582-83 (observing that the torts of corporations can be viewed as "caused" by shareholders' investments).

¹⁴⁴ Alexander, *supra* note 9, at 396.

stem from a constitutionally cognizable contact with that State.”¹⁴⁵ However, it also said that “[t]he forum State does not exceed its powers under the Due Process Clause if it asserts personal jurisdiction over a corporation that delivers its products into the stream of commerce with the *expectation* that they will be purchased by consumers in the forum State.”¹⁴⁶ The Court’s reference to the defendant’s expectation is crucial. The defendants in *World-Wide Volkswagen* were a New York automobile dealer and its regional distributor, which operated only in New York, New Jersey, and Connecticut. The plaintiffs, who had purchased an automobile from the defendant dealer and had been injured in an automobile accident in Oklahoma, sought to obtain jurisdiction over the dealer and distributor in Oklahoma. The Court specifically stated that there was nothing in the record that showed even that the defendants there “indirectly, through others, serve[d] or [sought] to serve the Oklahoma market.”¹⁴⁷ The Court clearly implied that if they had, the outcome of the case would have been different; that difference would have derived from the defendant’s expectation.

The plaintiffs’ argument in *World-Wide Volkswagen* was basically that their use of the automobile in Oklahoma was foreseeable, an argument that the Court rejected: “[T]he foreseeability that is critical to due process analysis is not the mere likelihood that a product will find its way into the forum State. Rather, it is that the defendant’s conduct and connection with the forum State are such that he should reasonably anticipate being haled into court there.”¹⁴⁸ The Court’s concern was that a defendant should not be required to appear in a distant forum as a result of “the mere ‘unilateral activity of those who claim some relationship with a nonresident defendant.’”¹⁴⁹ In that respect, *Burger King* and *World-Wide Volkswagen* are clearly different,¹⁵⁰ and shareholder liability is much closer to *Burger King*. In *Burger King*, the defendant sought out the connection with Florida by choosing to invest in a Burger King franchise, regardless of the fact that he dealt only with Burger King’s Michigan office. Similarly, a corporate shareholder, by investing in a corporation, establishes a connection—albeit an indirect one—with the states in which the

¹⁴⁵ *World-Wide Volkswagen*, 444 U.S. at 299 (citing *Kulko v. California Superior Court*, 436 U.S. 84, 94–95 (1978)).

¹⁴⁶ *Id.* at 297–98 (emphasis added) (citing *Gray v. American Radiator & Standard Sanitary Corp.*, 176 N.E.2d 761 (Ill. 1961)).

¹⁴⁷ *Id.* at 295.

¹⁴⁸ *Id.* at 297 (citations omitted).

¹⁴⁹ *Id.* at 298 (quoting *Hanson v. Denckla*, 357 U.S. 235, 253 (1958)).

¹⁵⁰ That is, they are factually different. The Court throughout *Burger King* cites *World-Wide Volkswagen*, suggesting that it sees no legal inconsistency between the two cases, and indeed there is none.

corporation does business. Both of these circumstances are very different from *World-Wide Volkswagen*, where the dealer and distributor established *no* connection, even indirectly, with Oklahoma; the connection was established purely by the automobile's purchaser. The crucial distinction is the defendant's knowledge and voluntary acceptance of the forum-state connection, neither of which was present in *World-Wide Volkswagen* but both of which were present in *Burger King* and would be present for a corporate shareholder.¹⁵¹

As the Court said in *World-Wide Volkswagen*, when the defendant purposefully avails itself of a state's laws, "it has clear notice that it is subject to suit there, and can act to alleviate the risk of burdensome litigation by procuring insurance, passing the expected costs on to customers, or, if the risks are too great, severing its connection with the State."¹⁵² All of these possibilities are available to corporate shareholders. If they are concerned about the risk of unlimited liability, they could purchase portfolio insurance (a possibility discussed by Hansmann and Kraakman¹⁵³), they could pass the cost on to the "consumer"—actually the corporation—by paying a lower price for the stock, or they could disinvest in the corporation. All that is necessary is that the shareholder have knowledge of her potential limited liability, and, as discussed in the next part of this article, she will.

IV. SHAREHOLDER ACCEPTANCE OF UNLIMITED LIABILITY

The cases discussed in the last section indicate the central question that must be answered in determining whether a party, liable for a debt in a state, is subject to jurisdiction there: did the party know of the forum-state connection of its liability? In the unlimited-liability context, then, the question would be whether shareholders purchased or held their shares with knowledge of their

¹⁵¹ Note that though the Court in *World-Wide Volkswagen* recognized that it was foreseeable that an automobile sold by the defendant dealer would be driven to Oklahoma, and determined that such foreseeability was not enough to establish jurisdiction, the Court rejected the view that "foreseeability is wholly irrelevant." *Id.* at 297. Instead, it said that if a defendant's in-state activity "is not simply an isolated occurrence, but arises from the efforts of the manufacturer or distributor to serve, *directly or indirectly*, the market for its product in other States, it is not unreasonable to subject it to suit in one of those States." *Id.* (emphasis added).

¹⁵² *Id.* at 297. The Court said that the jurisdictional requirements of the Due Process Clause "allow[] potential defendants to structure their primary conduct with some minimum assurance as to where that conduct will and will not render them liable to suit." *Id.*

¹⁵³ Hansmann & Kraakman, *supra* note 1, at 1901.

potential liability for corporate activities in the forum state.¹⁵⁴ That, in turn, would require that shareholders actively consider information relating to their liability exposure and that information regarding that exposure was readily available to them. The sections below conclude that both of these requirements would be met if unlimited liability were imposed.

A. Active or Passive Shareholders?

For shareholders' liability in a forum state to support jurisdiction over them, the shareholders must have taken an active and informed role in deciding to invest in a corporation doing business there. A shareholder's active role in making that investment decision allows him to control where he is subject to jurisdiction, and due process requires no more.¹⁵⁵ More particularly, due process does *not* require that shareholders play an active role in controlling the corporation itself. For that reason, Professor Alexander's references to "passive investor[s],"¹⁵⁶ "passive ownership of shares,"¹⁵⁷ and "mere ownership of shares,"¹⁵⁸ are not decisive. It is true that shareholders, at least shareholders of a public corporation, are passive as regards the management of the corporation,¹⁵⁹ but the important question is whether they are passive as regards the act that subjects them to liability, their decision to invest.¹⁶⁰

Many shareholders, even under current limited-liability law, are "active" investors in this sense. Rational shareholders base their investment decisions on the probable returns of their various investment options, so they will consider the potential for unlimited liability in deciding whether to purchase or hold a

¹⁵⁴ I do not intend here to beg the question; I use the term "potential" to reflect the fact that liability is not certain, rather than to refer to a certain obligation for a liability that may or may not in fact occur.

¹⁵⁵ See *World-Wide Volkswagen Corp.*, 444 U.S. at 297 (describing the test as whether the defendant is able "to structure [its] primary conduct with some minimum assurance as to where that conduct will and will not render [it] liable to suit"). See also *supra* part III.C-D.

¹⁵⁶ Alexander, *supra* note 9, at 398.

¹⁵⁷ *Id.*

¹⁵⁸ *Id.* at 396.

¹⁵⁹ Professor Alexander says that the shareholder must have "control over the actions of an in-state actor (the corporation)." *Id.* at 401. As part III.C.2, *supra*, showed, guarantors and insurers can be subject to jurisdiction in states where they have taken on liability, despite their lack of control over any actors in those states.

¹⁶⁰ See Hansmann & Kraakman, *supra* note 139, at 455 ("Under unlimited liability, small investors (indeed, all investors) who cannot control a corporation's affairs directly will decline to invest in the stocks of companies that do not adequately compensate investors for the liability risks that they impose.").

stock. As Judge Easterbrook and Professor Fischel, in their defense of limited liability, say: "Of course, rational shareholders understand the risk that the managers' acts will cause them loss. They do not meekly accept it. The price they are willing to pay for shares will reflect the risk."¹⁶¹ The alternative, that "[i]nvestors buy stock in the market and may know little more than its price,"¹⁶² is not plausible. Investors must know *something* other than price to decide in which corporation to invest. After all, they do not choose a stock merely because it is priced at, say, \$50; they choose it because, based on some other information, they expect its future price to be greater than \$50. That "other information" is the stock's likelihood of increasing in price or decreasing in price,¹⁶³ which includes the likelihood that its price will decrease below zero—*i.e.*, that it would subject its shareholders to liability.

It is true, of course, that acquiring information about a corporation's business activities is not costless. For that reason, it is likely to be more efficient for large shareholders than for small ones. Some empirical evidence bears this out. Professor Bernard Black provides a survey of the evidence comparing corporate stock ownership patterns with various measures of corporate performance.¹⁶⁴ The evidence indicates that corporate ownership by large shareholders adds value to corporations, and that institutional ownership may do so also, though there the evidence is less clear.¹⁶⁵ Professor Black argues that some of the increased performance is due to the monitoring of management by large shareholders,¹⁶⁶ though he acknowledges that it could simply reflect the direct and indirect effects of better stock-selection by large shareholders.¹⁶⁷ For present purposes, it does not matter, because either explanation relies on well-informed decision-making on the part of the large

¹⁶¹ Easterbrook & Fischel, *supra* note 5, at 94.

¹⁶² FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 15 (1991). In their recent book, Easterbrook and Fischel appear to have shifted toward this view. In the book's limited-liability chapter, they delete the passage quoted at note 161 *supra*. See EASTERBROOK & FISCHEL, *supra*, at 42.

¹⁶³ It is possible that this "other information" could come in the form of a broker's recommendation that a stock be purchased, in which case the investor herself might not have specific expectations regarding the corporation's expected future prices.

¹⁶⁴ See Bernard S. Black, *The Value of Institutional Investor Monitoring: The Empirical Evidence*, 39 UCLA L. REV. 895, 917-27 (1992).

¹⁶⁵ *Id.* at 917.

¹⁶⁶ See *id.* at 923-24, 927.

¹⁶⁷ See *id.* at 922 (noting indirect signalling effects), 927 (noting possibility that institutional investors might be good stock-pickers).

shareholders.¹⁶⁸ It seems likely, therefore, that at least those shareholders would be aware of their corporation's activities in an unlimited-liability state, and that jurisdiction over them would be supportable.

Moreover, however active shareholders are in evaluating information about their corporate investments in the current limited-liability regime, they would certainly become more active under unlimited liability. Indeed, commentators have argued for limited liability precisely because of a belief that under unlimited liability shareholders would have to engage in close monitoring of corporate activities.¹⁶⁹ This argument has generally been made under the assumption of joint and several shareholder liability, but shareholder monitoring would no doubt increase under a pro-rata system as well.¹⁷⁰ Shareholders' greater potential losses under any unlimited-liability system would justify a greater investment on their part to prevent such losses. Alternatively, shareholders under unlimited liability might alter their investment patterns. For example, they might shift their investments from individual stocks to mutual funds, in order to obtain the protection of the funds' diversification. In that case, the mutual fund would be the investment decision-maker, and because mutual funds, like other professional investors, take an

¹⁶⁸ Moreover, the better-stock-selection explanation is not subject to a recent critique of the claim that institutional investors will serve an important monitoring function. See Jill E. Fisch, *Relationship Investing: Will It Happen? Will It Work?*, 55 OHIO ST. L.J. 1009 (1994). Professor Fisch points out that the performance of an institutional investor is sometimes judged not in absolute terms, but in comparison with other investors against which it competes. *Id.* at 1019-22. When that is the case, and when investors competing against each other all stand to suffer comparable losses from unlimited liability, a single investor might not benefit from costly efforts to improve management performance and prevent such losses. That is so because the loss-prevention efforts could also confer benefits on the investor's competitors, which by investing in the same companies could free-ride on those efforts without themselves incurring their cost. *Id.* at 1022-25. In that case, the loss-preventing investor's performance would suffer, not improve, in comparison with its competitors. *Id.* But, as Professor Fisch observes, if an investor can appropriate private gains from its efforts, it can benefit from those efforts in relative terms as well as absolute ones. *Id.* at 1038-41. Thus, if an investor devotes its attention to selecting stocks, rather than to improving the performance of the companies in which it is invested, it can attain an advantage over its competitors (so long as those competitors were not able, or willing, to simply mimic its investment decisions). In the unlimited-liability context, therefore, an investor could benefit by selecting for low risk of unlimited shareholder liability.

¹⁶⁹ See, e.g., Easterbrook & Fischel, *supra* note 5, at 94-95; Halpern, *supra* note 1, at 135-36.

¹⁷⁰ But see Coffey, *supra* note 8, at 79-81 (arguing that pro rata shareholder liability would cause investors to reduce their holdings in individual corporations and therefore lower the return on monitoring).

active role in choosing their investments,¹⁷¹ a court would probably find that for them that jurisdictional requirement was met.

At bottom, of course, the nature of shareholder decision-making under unlimited liability will not be clear unless and until unlimited liability is imposed.¹⁷² One of the points of this article is that the imposition of unlimited liability would change the corporate landscape significantly.¹⁷³ It seems likely both that shareholders would treat their corporate investments differently, and that, as a result, courts would treat the corporation-shareholder relationship differently. Regardless of the exact form that relationship took, though, it seems likely that under unlimited liability corporate shareholders would be "active" decision-makers.

B. Shareholder Knowledge of Potential Unlimited Liability

Moving on to the specifics of the shareholder's decision, jurisdiction over a shareholder based on her unlimited liability would require that she know, and accept, that she could be liable in the forum state.¹⁷⁴ Professors Hansmann and Kraakman suggest a similar point in their response to Professor Alexander,¹⁷⁵

¹⁷¹ This statement applies primarily to mutual funds that attempt to maximize their returns, rather than to those, like index funds, that attempt to match the return of some specified target.

¹⁷² Some evidence on this issue is available in the example of American Express, which is described in the text accompanying notes 50–55 *supra* and notes 333–37 *infra*. One would also think that the California experience with unlimited liability, *see supra* notes 24–37, might provide an opportunity for empirical research on this question, despite the changes in the financial markets since California adopted limited liability in 1931. However, this opportunity apparently has not yet been taken. *See* BLUMBERG, *supra* note 1 § 2.01.1, at 46 ("The most interesting questions with respect to this fascinating episode in American corporate history are unanswered. . . . The issue of shareholder liability in California clearly poses a promising area for economic historians.").

¹⁷³ Other changes in current law could also change that landscape, of course. Some commentators have proposed other changes designed to promote more active monitoring and decision-making by corporate shareholders, *see, e.g.*, Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1992), and to the extent that those changes succeeded, they would strengthen the jurisdictional arguments made here.

¹⁷⁴ *Cf. supra* text accompanying notes 34–37 (discussing Supreme Court's apparent reliance in *Thomas v. Matthiessen*, 232 U.S. 221 (1914), on defendant shareholder's knowledge of California's unlimited-liability law).

¹⁷⁵ Hansmann & Kraakman, *supra* note 139, at 454–55. Professors Hansmann and Kraakman contrast the shareholder's decision under limited and unlimited liability by noting that even under limited liability a shareholder stands to lose the entirety of his investment as the result of a suit against the corporation in any state in which it does business:

but they do not consider whether in fact a shareholder would possess the required knowledge. As the following sections show, in most circumstances the shareholder would, though in some circumstances the connection between the corporation and the unlimited-liability state might be insufficiently significant to give rise to such knowledge.

1. Knowledge of Corporate Activities in an Unlimited-Liability State

If a state enacted unlimited liability, it is likely that information that a corporation was doing business in that state would be widely available. One does not have to share in the fears of some limited-liability advocates that unlimited liability would cause catastrophic market effects to believe that a state's imposition of unlimited liability would be a newsworthy event. The information would be widely distributed in the financial media, probably with analysis that discussed specifically which corporations the change was most likely to affect. Most shareholders, including at least professional investors, would know which corporations had significant unlimited-liability exposure, and where.¹⁷⁶ Such investors might even reduce their holdings after the imposition of unlimited liability, which would clearly indicate awareness of the change (as well as acceptance of its risk for remaining holdings).

To the extent that shareholders might otherwise remain unaware of the imposition of unlimited liability in a particular state, or might be unaware of their corporation's activities in that state, corporate disclosure could fill the void. Securities regulations require corporations to disclose to their investors information that would be material to the investor's investment decision, which the Supreme Court has defined as information for which there is "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of

Our proposed rule of pro rata shareholder liability merely alters this convention so that shareholders, upon investing in a corporation, are put on notice that they risk substantive liability not just up to the amount they invest, but rather, up to their pro rata share of *all* tort damages assessed against the corporation. Assuming that shareholders receive adequate notice of the new rule, there seems no reason why courts should not be able to assert jurisdiction sufficient to collect the full damages for which shareholders are liable under the substantive law.

Id.

¹⁷⁶ It is instructive in this context to compare unlimited liability with state anti-takeover provisions. Changes in anti-takeover provisions, though they arguably have considerably less likelihood of affecting stock prices, are widely publicized.

information made available.”¹⁷⁷ The risk that a corporation’s activities could subject its shareholders to unlimited liability would generally be known to the corporation itself,¹⁷⁸ so if that risk were material to its shareholders the corporation would be required to disclose it to the shareholders. If such disclosure were made, the shareholder should be charged with knowledge of her risk of unlimited liability. If such disclosure were not made, either because the risk was not material or because the corporation did not meet its disclosure requirements, jurisdiction might indeed be unavailable over shareholders, as is discussed in the next section.

2. *Immaterial or Undisclosed Corporate Activities in an Unlimited-Liability State*

The significance to a corporation’s overall financial results of its individual business activities, and hence of the laws by which those activities are governed, differs widely. Hence, if some state or states imposed unlimited shareholder liability, the significance of that change would depend on the nature and the extent of the corporation’s activities in that state.¹⁷⁹ For a corporation, say a bank, that operated in only one state, the liability laws of

¹⁷⁷ *Basic Inc. v. Levinson*, 485 U.S. 224, 231–32 (1988) (quoting *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)). The rules of the national stock exchanges are similar. For example, the New York Stock Exchange imposes the following requirement:

A listed company is expected to release quickly to the public any news or information which might reasonably be expected to materially affect the market for its securities. This is one of the most important and fundamental purposes of the listing agreement which the company enters into with the Exchange.

N.Y. Stock Exchange Listed Company Manual ¶ 202.05, *reprinted in* 3 Fed. Sec. L. Rep. (CCH) ¶ 23,519, at 17,214 (Oct. 18, 1989); *see also* American Stock Exchange Company Guide § 401(a) (“A listed company is required to make immediate public disclosure of all material information concerning its affairs, except in unusual circumstances.”), *reprinted in* American Stock Exchange Guide (CCH) ¶ 10,121 (1992).

¹⁷⁸ There might be rare exceptions, as when a corporation’s activities in a limited-liability state had unexpected effects in another, unlimited-liability state. *Cf. infra* text accompanying notes 179–85. In that case, the corporation would have no disclosure obligation, and the shareholder, if uninformed, would not be subject to jurisdiction in the unlimited-liability state.

¹⁷⁹ This assumes that a corporation’s activities in a state are governed by the shareholder-liability laws of that state, an issue that will be taken up in part V, *infra*, of this article.

that state would be the only ones of significance to its shareholders, because they would apply to the entirety of the corporation's business. If, however, that same bank had a branch in another state, the laws of that state might also be important to shareholders, though only if the amount of business done there were significant relative to the bank's overall business. If the corporation were not a bank but a manufacturing company, and the company sold its products nationwide, the liability rules of all the states might be of concern to shareholders, depending on the potential liabilities presented by the company's products. In sum, one can imagine a variety of arrangements of corporate activities, and for each the liability implications for corporate shareholders would be different.

These considerations, of course, apply under limited liability as well as under unlimited liability: a shareholder's losses always depend on the liability rules of the states in which its corporation does business. This fact is brought out quite clearly in one of the Supreme Court's jurisdictional cases, *Keeton v. Hustler Magazine, Inc.*¹⁸⁰ *Keeton* was a libel action brought against a magazine publisher in New Hampshire, the only state in which the statute of limitations for the action had not run. The publisher objected both to the assertion of jurisdiction over it in New Hampshire, where only a small fraction of its magazines were sold, and to being held liable there for damages relating to its sales nationwide under the "single publication rule" for libel damages,¹⁸¹ given that the action could not have been brought in any other state. The Court found the publisher's jurisdictional contacts with New Hampshire sufficient and rejected both its statute-of-limitations and damages arguments.¹⁸² By doing so, the Court subjected the publisher's shareholder to losses based on the peculiarities of New Hampshire law¹⁸³ in the same way that shareholders of a

¹⁸⁰ 465 U.S. 770 (1984).

¹⁸¹ The Court in *Keeton* quoted the following definition of the "single publication rule":

"As to any single publication, (a) only one action for damages can be maintained; (b) all damages suffered in all jurisdictions can be recovered in the one action; and (c) a judgment for or against the plaintiff upon the merits of any action for damages bars any other action for damages between the same parties in all jurisdictions."

Id. at 773 n.2 (quoting RESTATEMENT (SECOND) OF TORTS § 577A(4) (1977)).

¹⁸² *Id.* at 773-81.

¹⁸³ See *id.* at 779 ("[The plaintiff's] successful search for a State with a lengthy statute of limitations is no different from the litigation strategy of countless plaintiffs who seek a forum with favorable substantive or procedural rules or sympathetic local populations."); *id.*

corporation doing business in an unlimited-liability state would be subject to losses based on the laws of that state. That a shareholder's losses under unlimited liability could exceed her original investment, while her losses under limited liability are limited to the total investment, would not alter this principle.¹⁸⁴

The preceding paragraphs provide some context for the claim that corporations would be required to disclose to their shareholders the risk of unlimited liability if that risk were material. If the nature and extent of the corporation's activities in unlimited-liability states were significant, the corporation would be required to disclose information about those activities and their implications. Shareholders' decisions to purchase or hold shares in the corporation would then be made in light of information about their liability risks, and their knowledge and acceptance of their liability would be sufficient to subject them to jurisdiction to enforce it. Two questions then arise: would shareholders be subject to jurisdiction in a state in which the risk of unlimited liability was not material, and would they be subject to jurisdiction in a state where the risk was material but was not disclosed to them by the corporation?

If the risk of unlimited liability were immaterial, and the shareholder therefore were not informed of it,¹⁸⁵ jurisdiction over the shareholder should be unavailable, at least on the basis of her share ownership. Some shareholders would still be reachable, of course—shareholders that had other minimum contacts with the unlimited-liability state could be sued there, and shareholders could be sued in other states in which they had minimum contacts—but there probably would not be a forum in which an action could be brought against all the shareholders. It should be noted, though, that this is perhaps more a theoretical question than a real one. If a corporation's liability were in fact to exceed its assets, so that an action was brought against its shareholders for their unlimited liability, a claim by the corporation that it did not disclose the risk of finding itself in that situation because that risk was immaterial might not receive a sympathetic hearing.

This, then, raises the second question: What should be the result if a risk is material but is not disclosed to shareholders? I believe that in that case, also,

at 781 ("[S]ince [the publisher] can be charged with knowledge of the 'single publication rule,' it must anticipate that such a suit will seek nationwide damages.").

¹⁸⁴ That is, it would not alter the nature of the shareholder's losses, though it might alter their extent. For example, if a shareholder has invested \$10,000 in a corporation, and the corporation incurs considerable losses, of which her pro rata share is \$10,200, unlimited liability would increase her actual losses by only \$200/\$10,000, or 2%.

¹⁸⁵ It might still be possible to obtain jurisdiction over the shareholder if she had actual knowledge of the liability risk in the state, but proof of such knowledge would be available in only limited circumstances.

jurisdiction over the shareholders would be inappropriate, because the shareholders would not knowingly have accepted the risk of liability. This need not, however, as one might fear, create an incentive for corporate management to free shareholders from their liability by not disclosing it. Some shareholders would still be subject to jurisdiction in the unlimited-liability state, due to minimum contacts established with that state through other means. Those shareholders, because they would be caught unaware by their unlimited-liability obligation as a result of the management's failure to disclose material information, would have an action against the management for their losses, based on that failure to disclose. Moreover, because shareholders in this situation¹⁸⁶ would typically be large ones, with multi-state contacts, they would probably have both the resources and the incentive to bring such an action. The possibility of such actions should serve as the necessary incentive for management to disclose corporate activities that could lead to unlimited liability.

V. INTER-JURISDICTIONAL ISSUES

Choice of law may present a more serious obstacle to the imposition of unlimited shareholder liability than do jurisdictional concerns. That is especially so in that the jurisdictional rationale discussed above relies on substantive liability, which in turn depends on the choice of substantive law.¹⁸⁷ Nevertheless, it appears that, domestically at least, the shareholder liability law of the state in which a corporation does business should prevail over the corporation's state of incorporation, though perhaps only for certain corporations. This conclusion is reached in the first two sections below under both Commerce Clause and traditional choice-of-law analyses. Internationally, however, the issue is a more difficult one; as the third section below points out, other countries might refuse to enforce a U.S. unlimited-liability judgment.

¹⁸⁶ Note that although only certain shareholders—those who were subject to jurisdiction in the unlimited-liability state—could bring such an action, because only those shareholders would have suffered a loss, this rule would not impose inconsistent requirements on corporate officers and directors. Management's disclosure obligation would extend to all shareholders; it is simply that only those shareholders who suffered a loss would be entitled to a financial recovery, just as in a typical derivative disclosure action only those who purchased shares at a price affected by inadequate disclosure can recover. Moreover, other shareholders might be treated as having suffered a loss as well, because in the future they could be subject to suit in the unlimited-liability state if they established minimum contacts with that state.

¹⁸⁷ See *supra* note 99 and accompanying text.

A. Dormant Commerce Clause

A state's imposition of unlimited shareholder liability, like many other state laws, would affect out-of-state corporations and shareholders, but it does not appear that it would violate the dormant Commerce Clause. In fact, unlimited liability seems more likely to redress current Commerce Clause difficulties produced by limited shareholder liability than to introduce new ones. The current state of dormant Commerce Clause jurisprudence in the corporate-law context is set out in the Supreme Court's opinion in *CTS Corp. v. Dynamics Corp. of America*.¹⁸⁸ Although the Court's jurisprudence in this area has, as it acknowledged in *CTS*, "not always been easy to follow,"¹⁸⁹ it appears to have two strands. A state law may neither discriminate against out-of-state entities nor subject such entities to a burden of inconsistent state regulations.¹⁹⁰

1. Discriminatory Law

If an unlimited liability law applied to *any* corporation doing business in a state, the law would, in the words of *CTS*, "'visit[] its effects equally upon both interstate and local business.'"¹⁹¹ *CTS* rejected a Commerce Clause challenge to an antitakeover provision of Indiana's corporation law that stripped the voting rights from shares of an Indiana corporation acquired by an investor when the investor's ownership share exceeded a certain threshold.¹⁹² The investor could restore the voting rights to her shares only on a majority vote of "disinterested" shareholders.¹⁹³ Although the Indiana law imposed burdens on

¹⁸⁸ 481 U.S. 69 (1987).

¹⁸⁹ *Id.* at 87.

¹⁹⁰ See *id.* at 88 ("This Court's recent Commerce Clause cases also have invalidated statutes that may adversely affect interstate commerce by subjecting activities to inconsistent regulations.") (citations omitted); Daniel R. Fischel, *From MITE to CTS: State Anti-Takeover Statutes, the Williams Act, the Commerce Clause, and Insider Trading*, 1987 SUP. CT. REV. 47, 88 ("This 'inconsistent regulations' test appears to be distinct from the discrimination test.").

¹⁹¹ *CTS*, 481 U.S. at 87 (quoting *Lewis v. BT Inv. Mgrs., Inc.*, 447 U.S. 27, 36 (1980)).

¹⁹² *Id.* at 72-73. The law apparently applied to three different thresholds, 20%, 33-1/3%, and 50%, but the Court's opinion does not explain when the different thresholds applied. See *id.* at 73.

¹⁹³ *Id.* at 73-74. As the Court stated, "[i]nterested shares' are shares with respect to which the acquiror [*i.e.*, the investor who had acquired shares exceeding the statutory threshold], and officer, or an insider director of the corporation 'may exercise or direct the

the acquisition of Indiana corporations that did not apply to corporations in other states, the Court did not believe that that was the relevant inquiry. Instead, the key point was that the Indiana law applied equally to in-state and out-of-state investors: "Because nothing in the Indiana Act imposes a greater burden on out-of-state offerors than it does on similarly situated Indiana offerors, we reject the contention that the Act discriminates against interstate commerce."¹⁹⁴

A single state's unlimited-liability law would operate similarly. Although it would impose burdens on the shareholders of corporations that operated in Indiana that would be greater than those in other states, the burdens would be the same for in-state corporations (and shareholders) as they would be for out-of-state corporations (and shareholders). In fact, because it is likely that corporations incorporated in a particular state do a larger proportion of their business in that state than do out-of-state corporations, it seems likely that the burden of an unlimited liability law would fall most heavily on in-state corporations.¹⁹⁵

Moreover, in considering whether an unlimited-liability law is discriminatory, it must be remembered that the Commerce Clause issue arises only when a loss is imposed on in-state persons by out-of-state corporations (and, presumably, out-of-state shareholders). In such circumstances, it could reasonably be said that it is the limited-liability law of the state of incorporation that is discriminatory, because it allows shareholders of corporations chartered there to avoid tort judgments in other states. Under this view, an unlimited-liability law would not discriminate against out-of-state corporations or shareholders, but would merely correct the discrimination that would otherwise be imposed by other states' limited-liability laws. This idea—that a rule that the law of the state of incorporation governs is itself problematic under the dormant Commerce Clause—has previously been advanced by Professor Fischel.¹⁹⁶ He discusses it in the context of the market for corporate control,

exercise of the voting power of the corporation in the election of directors.'" *Id.* at 73 n.2 (quoting IND. CODE § 23-1-42-3 (Supp. 1986)).

¹⁹⁴ *Id.* at 88.

¹⁹⁵ I believe that, as I argue *infra* part V.B, a state's unlimited-liability law would apply only to corporations' activities in that state. If, instead, a state's unlimited-liability law applied to all corporations incorporated in that state, the statement in the text would be even more clearly true (since "in-state corporations" means corporations incorporated in the state).

¹⁹⁶ Professor Fischel makes the following comments:

Corporate law has long been based on the principle that a corporation is governed by the law of its state of incorporation. Corporations of any size, such as publicly held

where he believes that a discriminatory approach cannot endure, because shareholders will pay less for the shares of corporations incorporated in states that discriminate against them.¹⁹⁷ However, as Hansmann and Kraakman point out, shareholders would have no reason to seek to avoid a law that imposes costs not on them, but on tort victims in other states, so limited-liability laws, unlike antitakeover provisions, present a very real danger of a "race-to-the-bottom" effect.¹⁹⁸

2. *Inconsistent Regulation*

An unlimited liability law would also not subject either corporations or investors to inconsistent regulations, or in any event would not do so any more than other state economic regulations. The Court in *CTS* did not appear to consider inconsistent regulation a serious problem in the tort context that would apply to unlimited liability: "Firms that engage in interstate commerce are subjected to differing state regulations routinely. Firms that sell products in several states, for example, are subject to different tort rules in each state. Some states have a negligence rule, other have strict liability; some have liberal rules concerning the awarding of punitive damages, others do not."¹⁹⁹ Nevertheless, this issue is raised by Professor Alexander. The example that she gives is that of a state that would seek to impose unlimited liability through a

firms, have investors throughout the country. Thus it is routine for the law of a state where a corporation is incorporated to govern transactions between investors in other states.

At first blush, this system of corporate governance where the laws of individual states regulate transactions between individuals in other states might itself seem suspect under the dormant Commerce Clause.

Fischel, *supra* note 190, at 84.

¹⁹⁷ *Id.* at 67-70.

¹⁹⁸ See Hansmann & Kraakman, *supra* note 1, at 1921-22. A related point was made by *Joncas v. Krueger*, 213 N.W.2d 1 (Wis. 1973). *Joncas* considered the applicability to foreign corporations of a Wisconsin statute making shareholders pro rata liable for unpaid debts to employees for up to six months services. The court said that to exclude foreign corporations from application of the law would raise a question of the denial of equal protection to the employees of those foreign corporations, and the court said that it could "see no valid distinction why shareholders of foreign corporations should be favored or why Wisconsin employees working in Wisconsin should be classified for benefits depending upon where their employer is incorporated." *Id.* at 4 (citations omitted).

¹⁹⁹ Fischel, *supra* note 190, at 89.

“doing business” statute that would require an out-of-state corporation doing business in the state to adopt a charter provision making shareholders liable for tort claims against the corporation.²⁰⁰ Professor Alexander says that a conflict could arise if the corporation statute of another state, say Delaware, forbade unlimited liability. In that case, she says, “Delaware corporations would be unable to comply with both the law of the state of incorporation, which forbids unlimited liability, and the law of the state in which they do business, which requires unlimited liability.”²⁰¹ This may not really be a concern, for two reasons.

First, the imposition of unlimited liability would not require a doing-business statute like the one Professor Alexander describes. As discussed previously,²⁰² shareholders of a corporation could have jurisdictionally-adequate notice of the corporation’s business activities in an unlimited-liability state without any such statute.²⁰³ In the absence of such a statute, the suggested conflict would arise only if a state—perhaps seeking to attract incorporations²⁰⁴—were to enact a law stating that corporations incorporated there were not subject to unlimited liability regardless of the liability laws of the states in which they did business.²⁰⁵ It is no doubt theoretically possible that a state could enact such a law. However, such a statute would be no more likely to be upheld than a state statute that stated that the state’s corporations were not subject to the income tax laws of other states.²⁰⁶

Second, as a legal matter, Professor Alexander’s concern appears to be just another way of stating the choice-of-law problem. In *CTS*, the Supreme Court’s discussion of the inconsistent-regulation issue relied on a conception very similar to the corporate internal-affairs doctrine that is central to the choice of

²⁰⁰ Alexander, *supra* note 9, at 409–10.

²⁰¹ Alexander, *supra* note 9, at 410. Professor Alexander says that *CTS* suggests that it would be the doing-business statute that would have to give way. *Id.* As the text shows, that is by no means clear.

²⁰² See *supra* parts III & IV.

²⁰³ Professor Alexander discusses the doing-business statute in the context of imposing jurisdiction over shareholders on the basis of their notice of possible unlimited liability. See Alexander, *supra* note 9, at 408–10.

²⁰⁴ See *supra* text accompanying note 199.

²⁰⁵ The reference here is to a law that would go further than current corporate statutes, whose limits on shareholder liability could be said to include such a provision implicitly, and would attempt to decide the choice-of-law issues by explicitly stating that other states’ unlimited-liability laws would not be applicable.

²⁰⁶ Cf. *Barclays Bank PLC v. Franchise Tax Board*, 114 S. Ct. 2268 (1994) (upholding California’s combined reporting requirement for corporate franchise tax, despite the possibility that corporations could be exposed to multiple taxation).

law for corporate issues.²⁰⁷ The potential for inconsistent regulation to which the Court referred involved issues of corporate governance that were, in choice-of-law terms, corporate internal affairs.²⁰⁸ However, the Court in *CTS* did *not* view differing state regulations of corporate relationships with outside third parties as a Commerce Clause problem, as the passage quoted above demonstrates.²⁰⁹ Resolution of this issue thus requires a determination of whether shareholder liability is an internal or external matter, and that determination, as the next section shows, is a novel and difficult one.

B. *Choice of Law*

The central question in choosing the appropriate law to govern a corporation asks whether the particular issue involved is an internal one or one that involves third parties. This question is one that has not yet been answered in the context of shareholder liability;²¹⁰ furthermore, shareholder liability would be a change in the corporate structure so significant that it is difficult to extrapolate from current choice-of-law rules to resolve the question. I believe that the answer one reaches turns on whether one views the issue of shareholder liability for corporate torts as one of corporate law or of tort law.²¹¹ Although neither view is clearly correct, I suggest below that their relative attractiveness depends on the type of corporation and tort at issue.

1. *Corporate Internal Affairs*

As described earlier,²¹² the Supreme Court, when faced with the choice-of-law issue in considering California's unlimited-liability law in 1914, came down firmly on the side of applying the law of California. In that case, though,

²⁰⁷ See *infra* part V.B.1.

²⁰⁸ See *CTS*, 481 U.S. at 89 ("So long as each State regulates voting rights only in the corporations it has created, each corporation will be subject to the law of only one State.").

²⁰⁹ See *supra* text accompanying note 199.

²¹⁰ That is, it has not been answered in the context of general shareholder liability for debts incurred in the normal operation of a corporation; as is discussed *infra* text accompanying notes 215–17, the issue of shareholder assessments for capital deficiencies in the formation of a corporation is determined by the law of the state of incorporation.

²¹¹ Professors Hansmann and Kraakman argue that shareholder liability is a question of tort, not corporate, law. Hansmann & Kraakman, *supra* note 1, at 1916–19. They make this argument, however, with little discussion of the implications of factual distinctions among cases, which I believe are critical. See *infra* part V.B.2.

²¹² See *supra* text accompanying notes 30–37.

the Court was faced with a case involving a corporation that was apparently created specifically to do business in California.²¹³ The question of the appropriate choice of law on this issue more generally has apparently not yet been faced by the courts. Not surprisingly, then, the *Restatement (Second) of Conflict of Laws* is not very enlightening on the issue. The issue of shareholder liability falls directly in a gap between two sections of the *Restatement*.

Section 301 states that “[t]he rights and liabilities of a corporation with respect to a third person that arise from a corporate act of a sort that can likewise be done by an individual are determined by the same choice-of-law principles as are applicable to non-corporate parties.”²¹⁴ This rule, though sensible, is not very helpful; that the liability of the corporation should be governed by the local rule does not require that the same be true for the liability of a shareholder. Section 307, which is entitled “Shareholders’ Liability,” provides that “[t]he local law of the state of incorporation will be applied to determine the existence and extent of a shareholder’s liability to the corporation for assessments or contributions and to its creditors for corporate debts.”²¹⁵ Although this section appears at first glance to be helpful, and is treated as dispositive by Professor Alexander,²¹⁶ the comments to section 307 make clear that it applies only to the situation in which “liability is imposed upon the shareholders for such debts as the corporation incurs while engaging in business before its capital stock (or a portion of its capital stock) has been paid in.”²¹⁷ Neither section, then, decides which law should govern the liability to a third party of a shareholder of a corporation following the corporation’s initial capitalization.

An attempt to address the gap between sections 301 and 307 is made in section 302, which says that, for issues that are not covered by section 301,

[t]he local law of the state of incorporation will be applied to determine such issues, except in the unusual case where, with respect to the particular issue, some other state has a more significant relationship to the occurrence and the parties, in which event the local law of the other state will be applied.²¹⁸

²¹³ See *supra* note 34 and accompanying text.

²¹⁴ RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 301 (1969).

²¹⁵ *Id.* § 307.

²¹⁶ See Alexander, *supra* note 9, at 410 & n.119.

²¹⁷ RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 307 cmt. a (1969). Comment a also observes that “only shareholders who have not fully paid for their shares or who have paid otherwise than in cash may be made liable to creditors of the corporation for its debts.” *Id.*

²¹⁸ *Id.* § 302.

This rule, of course, only redirects the question to which state has the most significant relationship to the problem. On this, the *Restatement* says that

[a]mong the factors that bear upon the question are (1) the nature and extent of the corporation's relationship to the state of incorporation, (2) the nature and extent of the corporation's relationship to the state whose local law is sought to be applied and (3) whether the act is of the sort discussed in Comment e—namely, one which cannot practicably be governed by the local law of more than one state.²¹⁹

The third of these factors, whether the particular issue can be governed by the local law of more than one state, basically restates the inconsistent-regulation aspect of the Commerce Clause inquiry,²²⁰ which, as described above,²²¹ does not present a problem for shareholder liability. That leaves the

²¹⁹ *Id.* § 302 cmt. g. The Restatement also says, similarly, that “[t]he purpose sought to be achieved by the relevant rules of the potentially interested states, and the relation of these states to the transaction and the parties, are factors to be considered in determining the state of most significant relationship.” *Id.* § 302 cmt. c.

²²⁰ This conclusion is supported by comment e of § 302, to which the quoted passage from comment g refers. Comment e makes the following comments:

In addition, many matters involving a corporation cannot practicably be determined differently in different states. Examples of such matters, most of which have already been mentioned in Comment a, include steps taken in the course of the original incorporation, the election or appointment of directors and officers, the adoption of by-laws, the issuance of corporate shares (see Comment f), the holding of directors' and shareholders' meetings, methods of voting including any requirement for cumulative voting, the declaration and payment of dividends and other distributions, charter amendments, mergers, consolidations, and reorganizations, the reclassification of shares and the purchase and redemption by the corporation of outstanding shares of its own stock.

Id. § 302 cmt. e. All of these questions are corporate internal affairs, unlike the commission of a corporate tort against a third party. Comment e makes this explicit in the following comments, which immediately follow the paragraph quoted above:

Matters such as these must be contrasted with the acts dealt with in § 301, which include, for example, the making of contracts, the commission of torts and the transfer of property. There is no reason why corporate acts of the latter sort should not be governed by the local law of different states.

Id.

²²¹ See *supra* part V.A.2.

first two factors, which in this context are difficult to reconcile. The first refers to contacts with the state of incorporation, which are based on the corporate law of that state, and the second refers to contacts with the state in which the tort was committed, which are based on that state's tort law. The choice-of-law question thus requires a choice between tort law and corporate law.

2. Tort Law or Corporate Law?

It is not surprising that, at bottom, one's view of the proper choice of law for shareholder liability depends on one's views of the proper function and scope of tort law and corporate law. In some respects, this issue again presents the alternative views that appeared in the jurisdictional inquiry. From the corporate-law perspective of Professor Alexander,²²² shareholders are passive participants in the corporate enterprise who should not be held responsible for any acts of the corporation. From the tort-law perspective of Professors Hansmann and Kraakman,²²³ shareholders' investments, and their ability to decide where to place those investments, make shareholders efficient cost-avoiders and cost-bearers. Neither of these perspectives is without its problems.

On the one hand, the view that shareholders are passive investors that do not, and should not, have to take into account the potential losses of unlimited liability begs the question. As discussed earlier,²²⁴ if shareholder liability were made unlimited, it is unlikely that shareholders would remain as passive as they now are. Even in the current limited-liability regime, many investors, particularly professional investors, are quite aware of the specific activities in which their corporations engage, so that their investments are in effect votes approving of those activities. That shareholders are active investment decision-makers does not, of course, say that there are not substantive justifications for limited liability; it does, however, say that it is not enough simply to claim that shareholders are purely passive victims of corporate tort liability.

On the other hand, the view of Professors Hansmann and Kraakman that "shareholder liability for corporate torts should be viewed as a question of tort law rather than corporate law"²²⁵ is not self-evident, either. Their claim that

²²² See Alexander, *supra* note 9, at 398.

²²³ See Hansmann & Kraakman, *supra* note 1, at 1916-19.

²²⁴ See *supra* part IV.A.

²²⁵ Hansmann & Kraakman, *supra* note 1, at 1921. Professors Hansmann and Kraakman do not make this point in the jurisdictional context. Instead, they make it in arguing that it is principles of tort law, not corporate law, that should determine the appropriate limits to an unlimited liability regime and that should inform choice-of-law decisions. Their jurisdictional comments are made in passing in the choice-of-law

"[s]tate corporation statutes are commonly silent, or at least ambiguous, as to whether shareholders have limited liability for corporate torts," relying on a strained reading of the Delaware corporation statute,²²⁶ is not convincing. They also argue that applying the corporate law of the state of incorporation is inappropriate because, as noted above,²²⁷ competition among states for a shareholder-value-maximizing rule would lead to more limited liability.²²⁸ That is, given the nature of limited liability, corporate liability laws will be enacted in a "race for the bottom," so that looking to the law of the state of incorporation would itself be a substantive choice of limited liability. That seems clearly true, but it indicates only that one cannot rely on state corporate-law competition to produce desirable corporate law, not that current corporate law is necessarily inappropriate.

Hansmann and Kraakman temper their preference for tort law over corporate law by suggesting that the application of unlimited liability in tort should vary with the structure of the corporation at issue.²²⁹ They suggest that the justifications for imposing unlimited liability are strongest for corporations that are wholly-owned subsidiaries of other corporations, and that the justifications become less strong for publicly-held corporations and even less strong for corporations that are closely-held by individuals.²³⁰ In making this suggestion, though, Hansmann and Kraakman do not deviate from their view that the liability decision should be made purely on the basis of tort law, because their reasoning rests on whether the resulting liability would serve the risk-avoidance and risk-bearing purposes of tort law. They observe, for example, that because individual owners of a closely-held corporation are not easily able to diversify their risk, they are poor bearers of the risk of tort liability.²³¹

These considerations of tort law are important and should certainly be considered. However, corporate-law goals are also important, so it seems better not to confine the inquiry solely to tort law but to resolve these questions in the

discussion. *See id.* at 1922. Those comments are admittedly cursory—in fact, just two sentences—because the jurisdictional question is peripheral to their overall inquiry—whether unlimited shareholder liability is desirable, not whether it is feasible. It is largely these two sentences with which Professor Alexander's article takes issue.

²²⁶ Hansmann & Kraakman, *supra* note 1, at 1921 & n.108 (citing DEL. CODE ANN. tit. 8, § 102(b)(6)). For a convincing refutation of this claim, see Alexander, *supra* note 9, at 414–15.

²²⁷ *See supra* text accompanying note 198.

²²⁸ Hansmann & Kraakman, *supra* note 1, at 1921–22.

²²⁹ *Id.* at 1917–18.

²³⁰ *Id.*

²³¹ *Id.* at 1917.

context of a choice-of-law inquiry considering both bodies of law. In fact, corporate-law considerations sometimes support and sometimes oppose tort-law considerations. For example, the corporate-law goal of promoting the most efficient monitoring of corporate management has much in common with the tort-law goal of providing efficient risk-avoidance.²³² From both perspectives, it is sensible to impose full tort liability on corporate shareholders when shareholders are also management, as in parent-subsidiary relationships and in closely-held corporations.²³³ On the other hand, it can be argued that one of the goals of corporate law, and more particularly of limited liability, is to encourage the pursuit of risky business opportunities, and that goal is in direct conflict with the risk-avoidance goal of tort law.²³⁴ In this respect, the goals of

²³² The parallel is most close when tort damages are felt fully by shareholders, *i.e.*, when shareholder liability is unlimited.

²³³ The latter conclusion, that it is effective from a tort risk-avoidance perspective to impose unlimited shareholder liability on closely-held corporations, is in conflict with the conclusion of Professors Hansmann and Kraakman that imposing unlimited liability on such corporations could be undesirable. The conflict results from the focus of Hansmann and Kraakman on risk-bearing—from which they conclude that the shareholders of close corporations would find it difficult to diversify—and their neglect of risk-avoidance considerations. Cf. Hansmann & Kraakman, *supra* note 1, at 1917–18.

²³⁴ A recent article argues for the application of limited liability to close corporations for other reasons. See Richard A. Booth, *Limited Liability and the Efficient Allocation of Resources*, 89 Nw. U. L. REV. 140 (1994). Professor Booth's arguments are both descriptive and prescriptive. Descriptively, he says (by example) that even under limited liability shareholders are usually personally liable for corporate debts. In contract, this is true because creditors of a close corporation generally require shareholders to personally guarantee the corporation's debts. *Id.* at 154–55; see also *supra* note 105. In tort, Professor Booth argues that shareholders are often liable because they will themselves have committed the tort. Booth, *supra*, at 155–56. As Professor Booth recognizes, this probably goes too far, in that it would not apply to small corporations that have non-shareholder employees. *Id.* at 155. Professor Booth also argues, though, that because close corporations' shareholders often will not be diversified, they will be good monitors of their employees. *Id.* at 156–57. That may be true, but it is still the case that freeing shareholders of some of their liability will also free them of some of their incentive to monitor, a point that Professor Booth argues elsewhere supports unlimited liability. See *id.* at 147 (“Reduced to their essence, these arguments [that unlimited liability would require expensive monitoring] say that because the true cost of investing will sometimes exceed the benefit, some of the cost should be borne by others.”).

Prescriptively, Professor Booth concentrates almost exclusively on contract creditors, arguing that it is more efficient to place the burden of negotiating the terms of liability on creditors, as happens under limited liability, than on shareholders, as it would be under unlimited liability. *Id.* at 157–58. As to involuntary tort creditors, he would rely solely on

tort and corporate law may be irreconcilable, and it may truly be necessary to choose between them.

The choice between tort and corporate law should be made by considering the implications of both bodies of law for the facts of the particular case. Weighing the goals of both in light of the nature of the corporate activity at issue, one would find that unlimited shareholder liability would not always serve either the deterrence goal of tort law or the corporate-law goal of promoting risky economic activity. For example, if the chances of a particular corporate tort occurring were very low, but the injury that resulted from it was very high, it might not be effective to place the loss on the corporation's shareholders, especially if the corporation was a closely-held one; to do so might greatly discourage corporate activities of that kind, while perhaps providing little in the way of either deterrence or compensation²³⁵ for the tort victim. Conversely, if a particular corporate activity had a low chance of providing shareholders with a very high return, but a high chance of imposing risks on third parties, there seems no reason why shareholders should not be liable; to hold otherwise would be to encourage them to play the lottery at others' expense.

3. *An Analogy: Corporate Liability After Dissolution*

Before leaving this topic, it is worth pointing out an important analogy to unlimited shareholder liability: corporate liability after dissolution.²³⁶ From a choice-of-law perspective, whether a dissolved corporation's susceptibility to suit is governed by the laws of its state of incorporation or by those of the state where suit is brought presents much the same problem as unlimited liability. In each case, the answer requires a choice between the law applicable to the corporation's relationship with a third party and the law applicable to its own internal affairs. Moreover, in each case the fundamental effect of the result will be to determine the return to shareholders.

Although the states are not unanimous on this question, there appears to be a trend toward applying the law of the state in which the cause of action arose.

piercing the veil, *id.* at 164–65, and then apparently “only when the corporate form is used to perpetrate fraud or intentional harm,” *id.* at 143. In my view, that reflects an election of corporate-law principles at the expense of tort-law ones, when both should be considered.

²³⁵ The failure of unlimited liability to provide compensation would be largely dependent on the wealth of shareholders, but if the damages caused by a tort were very high, compensation would be less adequate.

²³⁶ I am indebted to Steve Bahls for pointing out this analogy to me.

At least one state, Montana, has recently established this rule by statute.²³⁷ According to the chair of the committee that drafted the Montana statute, the committee relied on the analysis of the issue in a California case, *North American Asbestos Corp. v. Superior Court*,²³⁸ in choosing its rule.²³⁹ *North American Asbestos* emphasized the fact that the state of incorporation has no necessary relation to the business of the corporation:

[W]hen we are considering a large national corporation doing business throughout the United States the singular interest of the state of incorporation is diminished. Being the state of incorporation does not establish it as the state in which the corporation conducts most of its business or has a majority of its shareholders. A state of incorporation is often selected on a basis of certain tax advantages or a liberal securities act.²⁴⁰

The court emphasized, in contrast, that California's relationship with an out-of-state corporation's activities can be more real, noting that "[w]hen a person suffers injury in California as a result of business conducted by a foreign corporation then qualified to do business within the state, California has a legitimate interest that the foreign corporation not be permitted to avoid responsibility for its wrongful act by withdrawing from the state."²⁴¹ Hence, because in *North American Asbestos* "the conduct giving rise to the cause of

²³⁷ MONT. CODE ANN. § 35-1-937(3) (1991) (Montana law regarding suits against dissolved corporations and their shareholders "appl[ies] to foreign corporations and their shareholders transacting business in [Montana] for any claims otherwise arising or accruing under Montana law.").

²³⁸ 225 Cal. Rptr. 877 (Ct. App. 1986).

²³⁹ See Steven C. Bahls, *Montana's New Business Corporation Act: Duties, Dissension, Derivative Actions and Dissolution*, 53 MONT. L. REV. 3, 50 (1992).

²⁴⁰ 225 Cal. Rptr. at 880.

²⁴¹ *Id.* at 880-81. Although this statement seems to rely on the corporation's registration to do business in California, it does not, notably, rely on any notion of consent, but on one of fairness. The court referred to a provision of the California Constitution that provided that "[n]o corporation organized outside the limits of this State shall be allowed to transact business within this State on more favorable conditions than are prescribed by law to similar corporations organized under the laws of this State." *Id.* at 881 (quoting CAL. CONST. art. XII, § 15 (repealed 1972)). The court observed that this section was in force when the California statute governing suits against dissolved corporations was enacted and that though the constitutional provision was repealed in 1972, its repeal was said to be a housekeeping measure only and to intend no change in law. *Id.* at 881-82. For that reason, the court read the statute in accordance with the repealed constitutional section. *Id.* at 882.

action and the injuries that were incurred took place within the state of California,"²⁴² the court applied California law to allow the suit.

Courts in other states have reached similar conclusions. Most make similar arguments of fairness, saying that a corporation doing business in a state should be subject to the restrictions in that state²⁴³ or that if a corporation seeks the benefits of doing business in a state, then it must also bear the costs.²⁴⁴ Other courts have relied on the corporation's greater connections with the forum state than with the state of incorporation.²⁴⁵ Some cases, it is true, apply the law of the state of incorporation, but those cases are for the most part quite old and apply a strict entity theory that would probably not be accepted today.²⁴⁶ More recently, even the cases that apply the law of the state of incorporation do so in situations in which that decision does not disadvantage forum-state residents²⁴⁷

²⁴² *Id.* at 880.

²⁴³ *See, e.g.,* W.T. Ratliff Co., Inc. v. Henley, 405 So. 2d 141, 144 (Ala. 1981) ("On public policy grounds, it would be unconscionable to allow a foreign corporation to do business in our state and then permit it upon its own volition and without any time limitation to leave those whom it has damaged with no recourse after its subsequent dissolution.").

²⁴⁴ *See, e.g.,* Advance Mach. Co. v. Berry, 378 So. 2d 26, 27 (Fla. Dist. Ct. App. 1979), in which the court stated:

To do so would permit a foreign corporation, which had done business in this State, to escape the effects of its tortious conduct after the expiration of only two years when the Florida law provided that liability should exist for at least three years. If the foreign corporation desired to take the benefits of doing business in Florida, then it should be subject to the same limitations as applicable to a domestic corporation upon dissolution.

Id. (footnote omitted).

²⁴⁵ *See* Ficor, Inc. v. McHugh, 639 P.2d 385, 391 (Colo. 1982) (en banc) (applying forum-state law because corporation did business only in forum state, but noting that result under law of state of incorporation would have been the same).

²⁴⁶ *See, e.g.,* Marion Phosphate Co. v. Perry, 74 F. 425, 428-29 (5th Cir. 1896); Bazan v. Kux Mach. Co., 190 N.W.2d 521, 524-25 (Wis. 1971).

²⁴⁷ *See* Gassert v. Commercial Mechanisms, Inc., 277 N.W.2d 392, 393-94 (Minn. 1979) (applying law of state of incorporation, but concluding that forum-state plaintiff's action was brought within corporate survival period). The law of the state of incorporation has also been applied to contract actions under the rationale that contract creditors accepted the terms of the corporation's state of incorporation, but that approach would not apply to tort victims. *See* Bayer v. Sarot, 381 N.Y.S.2d 489, 490-91 (App. Div. 1976) ("Persons outside of the state of domicile of the dissolved corporation are charged with knowledge of its statutes and are bound by them.") (citations omitted), *aff'd*, 364 N.E.2d 848 (N.Y. 1977).

or where the result would be the same under either law.²⁴⁸

Thus, the corporate dissolution cases seem to favor application of the law of the state in which the action arose. These cases do not, however, apply, at least explicitly, the sort of tort law-corporation law calculus advocated in the previous section. But when one considers the context of the dissolution cases, that is not surprising. When a corporation is dissolving, it is no longer possible to promote the goals of corporate law,²⁴⁹ and it seems logical that tort law should prevail. The situation is more difficult with unlimited shareholder liability and an ongoing corporation; in that case, corporate-law goals as well as tort-law goals are at stake, and a balance between the two bodies of law must be struck. Although the dissolution cases cannot help with this task, they do at least show that the law of the state of incorporation need not automatically be chosen whenever shareholder returns from corporate activities are at issue.

C. *International Choice of Law and Enforcement*

As a theoretical matter, the choice-of-law problems in the international context are not significantly different from those in the domestic context. Outside the United States, the choice-of-law rules applied to corporations have been similar to those of the *Restatement (Second) of Conflict of Laws*: internal corporate matters have been governed by the law of the country of incorporation,²⁵⁰ but a corporation's relations with third parties have been governed by the law applicable to the substantive relationship at issue.²⁵¹ More

²⁴⁸ See *Country Cupboard, Inc. v. Texstar Corp.*, 570 S.W.2d 70, 72-73 (Tex. Civ. App. 1978) (applying law of state of incorporation to decide that dissolved corporation has power to sue, but noting that result would be the same under forum law).

²⁴⁹ It is possible to promote the goals of corporate dissolution law, such as finality and certainty, and the cases do indeed take those goals into account. See, e.g., *North Am. Asbestos Corp. v. Superior Court*, 225 Cal. Rptr. 877, 880 (Ct. App. 1986). Those goals, however, seem primarily to benefit the dissolving corporation's shareholders, whereas the goals of corporate law can benefit society at large.

²⁵⁰ Internationally, the country of incorporation is sometimes seen as less important than its *siège réel* ("real seat"), the country of its domicile, ROBERT R. PENNINGTON, *COMPANIES IN THE COMMON MARKET* 98 (2d ed. 1970), but "[t]he law of the country of incorporation or the *siège réel*, whichever theory is accepted, not only determines the company's existence, but also in general governs the company's internal proceedings . . ." *Id.* at 100.

²⁵¹ See *id.* at 101, stating:

importantly, though, American courts deciding international choice-of-law issues typically apply rules similar to those that they use in deciding between the laws of different states of the United States.²⁵² Therefore, because a tort victim in an unlimited-liability state seeking compensation from a foreign corporation (or from a domestic corporation with foreign shareholders) almost certainly would bring suit in the unlimited-liability state,²⁵³ the victim would probably be as likely to receive an unlimited-liability judgment against the foreign corporation as he would against a domestic corporation.

As a practical matter, though, the absence of an international equivalent of the Full Faith and Credit Clause means that it is not enough that a victim in an unlimited-liability state obtain a judgment against a foreign corporation. Even if a U.S. court were to issue such a judgment, the victim would have to seek enforcement of that judgment against shareholders in other countries. As a matter of international law, there are two reasons why such enforcement might be denied. First, a U.S. court might lack personal jurisdiction over a foreign shareholder.²⁵⁴ Second, enforcement of an unlimited-liability judgment might

A company's proper law does not necessarily govern transactions with outsiders. These are governed by the proper law of the contract or other dealing, just as if the company had been an individual. Moreover, questions incidental to such transactions which concern the company's capacity or the powers of its representatives to bind it will be governed by the same law.

Id.

²⁵² See RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW OF THE UNITED STATES § 213, Reporters' Note 5 (1986) (noting that the principles of the *Restatement (Second) of Conflict of Laws*, though developed to resolve conflicts between the states of the United States, are also applied in the international context) (citing *Hausman v. Buckley*, 299 F.2d 696 (2d Cir. 1962), *cert. denied*, 369 U.S. 885 (1962)); see also Robert B. Thompson, *United States Jurisdiction over Foreign Subsidiaries: Corporate and International Law Aspects*, 15 LAW & POL. INT'L BUS. 319, 377-78 (1983).

²⁵³ The victim would be treated no less favorably (and probably more favorably) in that jurisdiction, and it would be less expensive to bring suit there.

²⁵⁴ An absence of personal jurisdiction will justify non-enforcement in both the U.S. and foreign countries. In the U.S., for example, twenty-five states, including California, New York, and Texas, had by 1994 adopted the Uniform Foreign Money-Judgments Recognition Act. See UNIFORM FOREIGN MONEY-JUDGMENTS RECOGNITION ACT, 13 U.L.A. 63, 63 (1995 Supp.) (listing jurisdictions). The Act provides that a foreign country's judgment is not conclusive if "the foreign court did not have personal jurisdiction over the defendant." UNIFORM FOREIGN MONEY-JUDGMENTS RECOGNITION ACT § 4(a)(2), 13 U.L.A. 261, 268 (1986). Similar provisions are applicable elsewhere. See, e.g., Convention on Jurisdiction and the Enforcement of Civil and Commercial Judgments, Sept. 27, 1968, arts.

be seen as against the public policy of the country in which it was sought to be enforced.²⁵⁵

Neither of these two reasons for non-enforcement would apply to foreign shareholders of U.S. corporations. Such shareholders would have the same notice of their potential unlimited liability as would U.S. shareholders, so jurisdiction over them would be appropriate for the same reasons.²⁵⁶

26, 27(2), 31, 34, 1969 Bull. Eur. Comm., No. 2, Supp. 17, 29-31 (providing for recognition and enforcement by contracting states of judgments of other contracting states, but that recognition "shall . . . not be accorded" and enforcement "may be dismissed" if "the defaulting defendant was not served with the summons correctly and in good time for him to arrange for his defence").

²⁵⁵ See, e.g., UNIFORM FOREIGN MONEY-JUDGMENTS RECOGNITION ACT § 4(b)(3), 13 U.L.A. 261, 268 (1986) (foreign country's judgment need not be recognized if it "is repugnant to the public policy of this state"); Convention on Jurisdiction and the Enforcement of Civil and Commercial Judgments, Sept. 27, 1968, arts. 26, 27(1), 31, 34, 1969 Bull. Eur. Comm., No. 2, Supp. 17, 29-31 (providing for recognition and enforcement by contracting states of judgments of other contracting states, but that recognition "shall . . . not be accorded" and enforcement "may be dismissed" if judgment is "contrary to 'public policy' in the State applied to"); cf. *Tahan v. Hodgson*, 662 F.2d 862, 866-67 (D.C. Cir. 1981) (deciding that enforcing an Israeli judgment piercing the corporate veil was not against U.S. public policy). It should be noted that, formally at least, a refusal to enforce a judgment as against public policy is not the same as a re-examination of the merits of the judgment. See, e.g., UNIFORM FOREIGN MONEY-JUDGMENTS RECOGNITION ACT § 3, 13 U.L.A. 261, 265 (1986) (foreign judgment that meets the requirements of the Act "is conclusive between the parties to the extent that it grants or denies recovery of a sum of money"); Convention on Jurisdiction and the Enforcement of Civil and Commercial Judgments, Sept. 27, 1968, arts. 29, 35, 1969 Bull. Eur. Comm., No. 2, Supp. 17, 30-31 (stating that in or under "no circumstances may the foreign judgment be reviewed as to the merits"). The public-policy test will allow enforcement even in cases in which the enforcing court would have reached a different decision on the merits. See *Drexel Burnham Lambert Group Inc. v. A.W. Galadari*, 610 F. Supp. 114, 118 (S.D.N.Y. 1985) ("Under New York law . . . foreign decrees and proceedings will be given respect under principles of international comity in the absence of significant countervailing public policy reasons, even if the result under the foreign proceeding would be different than under American law.") (citations omitted), *aff'd in part, vacated in part on other grounds*, 777 F.2d 877 (2d Cir. 1985).

²⁵⁶ It is possible, of course, that some foreign courts would not recognize the bases for jurisdiction discussed *supra* parts III & IV. However, some foreign shareholders would have significant contacts with the United States in any case, and others might be subject to jurisdiction as a result of their use of U.S. bank accounts (perhaps for receipt of dividends), see, e.g., *United Rope Distributors, Inc. v. Kimberly Line*, 770 F. Supp. 128 (S.D.N.Y. 1991), or their trading through U.S. brokerage firms, see, e.g., *S.E.C. v. Foundation Hai*, 736 F. Supp. 465 (S.D.N.Y. 1990), *aff'd in relevant part on other grounds*, *S.E.C. v.*

Furthermore, a foreign country's corporation law, which would be the source of its public policy, if any, against unlimited liability, would apply only to corporations incorporated (or domiciled²⁵⁷) in that country. For a U.S.-incorporated corporation, the only limited-liability policy that would be implicated would be that of the U.S. state of incorporation, and even a foreign court would presumably defer to a U.S. court's weighing of that policy.²⁵⁸ As Judge Oda of the International Court of Justice said in his concurring opinion in the *ELSI* case,²⁵⁹

Unifund SAL, 910 F.2d 1028, 1033 (2d Cir. 1990) (relying on effects of defendant's trading activities in U.S.).

²⁵⁷ See *supra* note 250.

²⁵⁸ A refusal to enforce the judgment on public policy grounds would require a conclusion that it is public policy of the European forum that its citizens be subject only to limited liability, regardless of the law of the country under which the corporation they invest is organized. See Thompson, *supra* note 252, at 378 ("One state is not likely to insist on limited liability to encourage investment in a second state if the second state does not want the economic benefits that limited liability is said to encourage.").

²⁵⁹ Case Concerning Elettronica Sicula S.p.A. (*ELSI*) (U.S. v. Italy), 1989 I.C.J. 15 (July 20). In the *ELSI* case, the International Court of Justice considered claims of the United States under its Treaty of Friendship, Commerce and Navigation (FCN Treaty) with Italy. The United States has concluded FCN treaties with many of its important trading partners, including Korea, the Netherlands, Germany, Japan, Denmark, Israel, Italy, China, and France. See Sean D. Murphy, *The ELSI Case: An Investment Dispute at the International Court of Justice*, 16 YALE J. INT'L L. 391, 394-99 & 396 n.15 (1991) (giving brief history of United States FCN treaties). The United States has also entered into bilateral investment treaties, see *id.* at 397-98 & 397 n.19, but those treaties apply generally to developing countries, so they are less relevant in the present context.

In *ELSI*, the United States claimed that the requisition by the Mayor of Palermo of the plant and related assets of an Italian corporation that was wholly owned by Raytheon Co., a U.S. corporation, was a violation of provisions of the FCN Treaty that gave U.S. nationals the right "to organize, control and manage" corporations in Italy and that protected the property rights of U.S. nationals in Italy. The court rejected the claims on the grounds that Raytheon in fact lost its rights in *ELSI* not due to the requisition, but to "the precarious financial state of *ELSI*, ultimately leading inescapably to bankruptcy." *Id.* at 81.

Judge Oda in his concurring opinion focused specifically on the rights of Raytheon as the shareholder of *ELSI*, observing that the United States should have relied on the provisions of the FCN Treaty that protect the interests of Raytheon as a shareholder, "albeit in an indirect way." *Id.* at 92 (Oda, J., concurring). (The judgment had referred to the question of whether Raytheon's indirect rights as a shareholder were protected, but it declined to resolve the question. *Id.* at 70-71.) Even under that interpretation, though, Judge Oda noted that there had been no showing that *ELSI* had been treated less favorably than corporations controlled by Italians, which he said disposed of the United States claim. *Id.* at 92-93 (Oda, J., concurring).

It is a great privilege to be able to engage in business in a country other than one's own. By being permitted to undertake commercial or manufacturing activities or transactions through businesses incorporated in another country, nationals of a foreign country will obtain further benefits. Yet these local companies, as legal entities of that country, are subject to local laws and regulations; so that foreigners may have to accept a number of restrictions in return for the advantages of doing business through such local companies.²⁶⁰

If, however, a U.S. court issued a judgment imposing unlimited liability on the foreign shareholders²⁶¹ of a foreign corporation, enforcement could be difficult. Because the foreign corporation might have no obligation to disclose to its shareholders their possible liability exposure, the basis for jurisdiction over the shareholders might not be apparent. Even for those shareholders over whom jurisdiction could be obtained,²⁶² a foreign court could treat its corporation law as an expression of a policy against unlimited liability and therefore refuse enforcement.²⁶³ The likelihood of such an action, though, is

²⁶⁰ *Id.* at 90-91 (Oda, J., concurring).

²⁶¹ An attempt to enforce a U.S. judgment against U.S. shareholders of a foreign corporation could be made in a U.S. court, so the Full Faith and Credit Clause would apply to mandate enforcement.

²⁶² *See supra* note 256.

²⁶³ The foreign corporation would have to have legitimate connections with its state of incorporation, though; it is unlikely that a U.S. corporation could incorporate a subsidiary in Europe specifically to avoid unlimited liability in the United States. This point was touched on in *Case Concerning the Barcelona Traction, Light and Power Company, Ltd. (Belgium v. Spain)*, 1970 I.C.J. 3 (Feb. 5). In *Barcelona Traction*, Belgium brought claims on behalf of Belgian shareholders in a Canadian corporation that had been the subject of a bankruptcy judgment in Spain, and whose assets there had been seized. The court rejected the claims on the grounds that the Spanish action was one against the corporation, not against the shareholders, so that the claims could properly have been brought only by Canada. However, the International Court of Justice pointed out, apparently with approval, that some States refuse to give their protection to companies incorporated there unless they have a business or a substantial number of shareholders there, and it said that "[o]nly then, it has been held, does there exist between the corporation and the State in question a genuine connection of the kind familiar from other branches of international law." *Id.* at 42. *See also* RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW OF THE UNITED STATES § 213 cmt. c (1986) ("As in the case of an individual, a state may refuse to treat a corporation as a national of the state that created it, and reject diplomatic protection by that state, where there is no 'genuine link' between them.") (citing RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW OF THE UNITED STATES § 211 cmt. c (1986), which discusses the concept of a "genuine link"); Thompson, *supra* note 236, at 380-96 (advocating weighing of national interests, rather than strict use of law of country of incorporation, to determine propriety of applying U.S. law to foreign subsidiaries of U.S. corporations); *cf.* *First Nat'l City Bank v.*

uncertain.²⁶⁴ The United States has bilateral investment treaties with many foreign countries, and most such treaties provide only that foreign corporations doing business in the U.S. be treated no less favorably than U.S. corporations.²⁶⁵ Moreover, the European Community seems more willing, at

Banco para el Comercio Exterior de Cuba, 462 U.S. 611 (1983) (holding that the separate juridical status of a public corporation established by the government of Cuba, though presumptively valid, could be ignored to prevent the Cuban government from bringing suit in the U.S. courts while at the same time using the corporation to shield itself from a counterclaim).

²⁶⁴ The only case that I have been able to find on point is *Risdon Iron & Locomotive Works v. Furness*, [1906] 1 K.B. 49 (Eng. C.A.), in which California creditors of an English limited-liability company sought to impose liability on one of the company's shareholder under California's unlimited-liability law. The court rejected liability, but emphasized that it did so because liability was sought to be imposed "merely from the provisions in the [articles of incorporation]" that authorized the company to do business in California. *Id.* at 56. The articles, however, did not refer specifically to California, *id.* at 50, and the court apparently relied on that fact:

I do not express an opinion as to how the case would stand if the defendant were shewn to have in fact assented to the company carrying on business in California on the terms that he should incur personal liability in accordance with the law of that State. If this were shewn, or if facts were proved from which it could be inferred that he had authorized the mode of trading under the particular conditions which imposed a liability on him, the case might be different.

Id. at 56. Thus, the court at least tentatively suggested a test similar to the one suggested above for jurisdictional purposes, i.e., a test that looks to the shareholder's actual or constructive knowledge of the unlimited-liability law of the state in which its corporation is doing business.

Because of the rarity of unlimited liability, there are few other cases to which one can look. However, Professor Pennington says that German courts have held that "the personal liability of shareholders on contracts made by their company is governed by the proper law of the contract." PENNINGTON, *supra* note 250, at 101 (citing Judgment of Oct. 29, 1938, RG, 159 Entscheidungen des Reichsgerichts in Zivilsachen [RGZ] 33; Judgment of May 27, 1910, RG, 73 RGZ 366). Professor Pennington also notes, though, that no other European courts have done the same. *Id.*

²⁶⁵ See, e.g., M. SORNARAJAH, *THE INTERNATIONAL LAW ON FOREIGN INVESTMENT* 250-52 (1994). Professor Sornarajah discusses bilateral investment treaties and observes that national treatment is the most favorable to foreign investors of the several standards of treatment in such treaties. *Id.* at 251. His description of the implications of national treatment makes clear, though, that under it unlimited liability could be applied to foreign investors if the same treatment were applied to U.S. investors: "National treatment may,

least in parent-subsidiary and other related-corporation situations, to pierce the veil than are U.S. courts.²⁶⁶ And at least one commentator has suggested that the laws of the member states of the European Community, and of the Community itself, are shifting away from limited liability.²⁶⁷ Nevertheless, the possibility exists that a foreign court would refuse to enforce a U.S. unlimited-liability judgment, and it is worth considering the impact of that possibility on the effectiveness of unlimited liability.

It seems unlikely that foreign investment difficulties would subvert a U.S. state's imposition of unlimited liability. First, it might be possible to eliminate the ability of shareholders of a foreign corporation to resist enforcement of an unlimited-liability judgment. Professors Hansmann and Kraakman suggest that such "international opportunism" could be prevented by, for example,

denying the right to conduct certain types of business within the United States to any firm incorporated in a nation that refuses to recognize unlimited liability for corporate torts, or requiring the posting of bond or proof of adequate insurance for potential tort damages by such a corporation before it can conduct business.²⁶⁸

Second, even if such preemptive techniques were unsuccessful, the problem itself might not be a large one. As discussed above, enforcement would present a difficulty only for corporations that were both incorporated in and legitimately based in foreign countries.²⁶⁹ Although the number of such corporations doing business in the U.S. that could incur tort liabilities greater than their assets is probably not zero, it is also probably not large. It seems likely that, on the whole, corporations doing business internationally are larger, and hence more likely to have assets sufficient to meet tort judgments against

however, rebound on the foreign investor. A harsh measure taken against the nationals may be extended to the foreign investor on the basis of national treatment." *Id.*

²⁶⁶ See Eran Aharon Lev, *European Community Competition Law: Is the Corporate Veil Lifted Too Often?*, 2 J. TRANSNAT'L L. & POL'Y. 199, 204-26 (1993) (discussing the EEC's Economic Unit Theory). See also Yitzhak Hadari, *The Choice of National Law Applicable to the Multinational Enterprise and the Nationality of Such Enterprises*, 1974 DUKE L.J. 1. It is not entirely clear what one should make of this. It might suggest that European courts would be more receptive to unlimited liability; it might also suggest that, because veil-piercing is available, there would be less justification for unlimited liability.

²⁶⁷ See David L. Perrott, *Changes in Attitude to Limited Liability—the European Experience*, in LIMITED LIABILITY AND THE CORPORATION 81, 106-15 (Tony Orhml ed. 1982).

²⁶⁸ Hansmann & Kraakman, *supra* note 1, at 1922-23.

²⁶⁹ See *supra* note 263 and text accompanying notes 261-65.

them, than are domestic corporations. This would be particularly true for corporations in those areas, such as pharmaceutical and chemical manufacturing, that would be especially likely to generate an unlimited-liability judgment. Thus, although one cannot rule out the possibility that foreign enforcement could present some difficulties for unlimited liability, it is far from clear that the obstacles would seriously diminish its overall effectiveness.

VI. FINANCIAL-MARKET OBSTACLES TO UNLIMITED LIABILITY

Professor Grundfest's financial-market arguments rely on the existence of "a class of shareholders . . . having substantial investable wealth without having assets that plaintiffs could reach under a regime of proportionate liability."²⁷⁰ Shareholder wealth could be unreachable, he says, "because of the constitutional and practical problems" of collecting proportionate liability ("unlimited-liability") judgments.²⁷¹ Although Professor Grundfest argues, relying on Professor Alexander's article, that these constitutional and practical problems would exist both domestically and internationally, the argument was made above²⁷² that domestic shareholders' assets would be reachable under unlimited liability. For foreign shareholders, the issue is less clear. As the last section pointed out,²⁷³ there would probably not be any legal difficulty in reaching the assets of foreign shareholders of at least U.S. corporations, but there could be practical difficulties, primarily because those assets might be difficult to find.²⁷⁴ Hence, this is the stronger aspect of Professor Grundfest's argument, and it is the one that will be addressed here.²⁷⁵

Professor Grundfest presents three basic ways in which the existence of shareholders with difficult-to-reach assets—what he calls "attachment-proof" shareholders and I will call "remote" shareholders²⁷⁶—could subvert an attempt to impose unlimited liability. These three methods are arbitrage among

²⁷⁰ Grundfest, *supra* note 9, at 395.

²⁷¹ *Id.*

²⁷² See *supra* parts III & IV (constitutional problems), part III.B (practical problems).

²⁷³ See *supra* text accompanying notes 258–60.

²⁷⁴ See Grundfest, *supra* note 9, at 398 & n.44.

²⁷⁵ Because foreign equity ownership is the worst-case scenario, much of the argument here applies as well to domestic shareholders, thus supplementing the arguments presented earlier.

²⁷⁶ As will become apparent below, Grundfest's use of the term "attachment-proof," see, e.g., Grundfest, *supra* note 9, at 389, begs the central issue in his argument. "Remote" is a less conclusory adjective, and is also used, though less frequently, by Grundfest. See, e.g., *id.* at 400.

different groups of investors,²⁷⁷ alterations in the capital structure of corporate issuers,²⁷⁸ and the creation of new derivative financial instruments by third parties.²⁷⁹ Professor Grundfest explicitly relies on the existence of remote investors for only the first of these approaches,²⁸⁰ but their existence is no less necessary for the other two.²⁸¹ Therefore, this part of the article proceeds by first examining the likelihood and the significance of the existence of a class of remote investors. I conclude that some such investors might exist, but their number would probably not be great and their existence would in any event not prevent the price of risky equity from dropping. The subsequent sections then show why a drop in risky equity prices would prevent each of Professor Grundfest's three avoidance mechanisms from defeating unlimited liability. Finally, the last section briefly discusses an example of unlimited liability that currently exists in the financial market: short sales. None of the effects predicted by Professor Grundfest has evolved for short sales, suggesting that they would also not evolve for unlimited liability

A. Remote Shareholders and Equity Prices

Professor Grundfest contends that financial-market effects would prevent unlimited liability from changing the prices of risky equity.²⁸² For this to be true, all of the risky equity must be owned by investors for whom the possibility of unlimited liability is a matter of no concern.²⁸³ Professor

²⁷⁷ *Id.* at 394.

²⁷⁸ *Id.* at 407.

²⁷⁹ *Id.* at 408.

²⁸⁰ *Id.* at 394.

²⁸¹ There is actually one exception, which is discussed below. *See infra* text accompanying notes 314–15.

²⁸² *See* Grundfest, *supra* note 9, at 392–93.

²⁸³ At one point, Professor Grundfest says that it is not actually necessary that all risky equity be held by attachment-proof investors, only that the price of the equity be set by the attachment-proof investors. *Id.* at 400 n.52. He says that that condition will be met as long as the marginal shareholders are attachment-proof. *Id.* If Professor Grundfest intends by this to say that unlimited liability would meet its goals only in part if a corporation is owned by both attachable and attachment-proof investors, that is true. If, however, he intends to suggest that so long as the marginal shareholders are attachment-proof, the goals of unlimited liability will be entirely evaded, that is incorrect. If some investors are attachable, both the compensatory and deterrent aspects of unlimited liability will in part be met. The compensatory goals will be met to the extent that liability can be imposed on the attachable shareholders. The deterrent goals will also be met, though, to the extent that the price paid by marginal shareholders (whoever they are) is lower because the attachable shareholders

Grundfest provides little information to suggest that this is likely. It is perhaps true, as he suggests, that risky equity would be disproportionately owned by investors whose assets were difficult to reach. It does not follow, however, that the riskiness of the equity would therefore have no price effects. As the following sections discuss, a drop in the price of risky equity under unlimited liability could result from at least three sources: an insufficient number of remote investors, an unwillingness of remote investors to own risky equity without compensation for the risk of an unlimited-liability judgment, and the illiquidity that would result from the concentration of the ownership of risky equity in the hands of a limited group of remote shareholders.

1. *The Number of Remote Shareholders*

It is not an easy task to estimate the amount of remote capital that would be available to own risky equity. At a minimum, one must compare the pool of available remote capital with the amount of risky equity. In this vein, Professor Grundfest observes that "[i]n 1989, aggregate foreign purchases and sales of securities in U.S. markets amounted to \$416.3 billion."²⁸⁴ It is difficult, however, to extract any relevant information from this number, for at least two reasons. First, by referring both to purchases and sales, it places no limit on how many times the transfer of a particular amount is counted. For example, the transactions of a foreign investor who bought and sold a block of Union

are unwilling to accept the liability risk for free. In that case, the corporation is presumably not owned entirely by attachment-proof investors because some such investors' expectations regarding the corporation's prospects are not sufficiently good to make it an attractive purchase despite the lower price reflecting attachable shareholders' unlimited-liability concerns. (In other words, Grundfest's argument apparently posits a downward-sloping demand curve for the risky equity. But as long as the shape of that curve is affected by attachable investors' responses to the equity's liability risk, the price of the equity will also be affected.)

It is possible, of course, that an attachable investor could choose to own some risky equity, or could by agreement choose to bear some of the unlimited-liability risk of equity owned by attachment-proof investors. In either case, the risky equity would not all be owned by attachment-proof investors, but the price of the equity would drop directly to the extent that its risk was borne by the attachable investors.

²⁸⁴ Grundfest, *supra* note 9, at 398 (citing Joseph A. Grundfest, *Internationalization of the World's Securities Markets: Economic Causes and Regulatory Consequences*, 4 J. FIN. SERVICES RES. 349, 353 (1990)). Note that although Professor Grundfest refers to "securities," the number he provides apparently refers to stocks only. See Office of the Secretary, Department of the Treasury, Treasury Bulletin 99 (Sept. 1992) (for 1989, listing the total foreign purchases of domestic stocks as \$214.071 billion and total sales as \$204.129 billion, for an "aggregate" of \$418.2 billion).

Carbide shares three times during 1989 would have been counted six times in the figure Grundfest provides; that investor's capital, though, could have been used only once to purchase and hold risky U.S. equity. Second, the total dollar amount of foreign trading is of little import unless compared to the amount of risky capital to be bought.

In fact, the likelihood that foreign investors could purchase all United States risky equity is low. Although the "aggregate foreign purchases and sales" of U.S. stocks have, as Professor Grundfest says, been \$350-400 billion dollars in recent years,²⁸⁵ *net* foreign purchases have been much lower. Net purchases from for the four years from 1988 to 1991 were in fact only \$3.9 billion, with some years showing net purchases and others net sales.²⁸⁶ At the end of 1991, the total capitalization of the New York Stock Exchange alone was \$3.71 trillion.²⁸⁷ Therefore, assuming that ten percent of NYSE issues were perceived as presenting a risk of unlimited liability, foreign investment in the U.S. equity markets would have to be 100 times the net 1988-1991 investment to hold all U.S. risky equity. That possibility seems unlikely and Professor Grundfest has provided no evidence to support it.

Moreover, a large increase in foreign investment to purchase risky U.S. equity is particularly unlikely because the imposition of unlimited liability would not make risky equity *more* attractive to foreign investors. At most, if foreign investors believed that they were at *no* risk of an unlimited-liability judgment, risky equity would remain as attractive as it was prior to the imposition of unlimited liability. So, however, would safe equity.²⁸⁸ For that reason, to estimate the amount of capital available to purchase risky equity by looking at total trading volume is misleading. A large fraction of the total trading volume could be diverted to risky equity only if risky equity became *more* attractive to investors, which would only occur—even if the investors perceived no unlimited liability risk to themselves—if risky equity prices dropped. This issue will be discussed more fully in the context of arbitrage

²⁸⁵ The actual totals have been the following: for 1988, \$364.370 billion; for 1989, \$418.200 billion; for 1990, \$361.712 billion; and for 1991, \$411.320 billion. Office of the Secretary, Department of the Treasury, Treasury Bulletin 99 (Sept. 1992).

²⁸⁶ The numbers for the individual years were the following: for 1988, net sales of \$2.000 billion; for 1989, net purchases of \$9.941 billion; for 1990, net sales of \$15.126 billion; and for 1991, net purchases of \$11.088 billion. Office of the Secretary, Department of the Treasury, Treasury Bulletin 99 (Sept. 1992).

²⁸⁷ Douglas R. Sease, *Why There May Be More Cash to Fuel a Rally*, WALL ST. J., Mar. 9, 1992, at C1 (Abreast of the Market).

²⁸⁸ Actually, a shift of some investors from risky equity to safe equity might raise the price of safe equity somewhat. But since there is presumably much more safe equity than risky equity, this effect is likely to be small.

below,²⁸⁹ but it is worth noting here that if a risky corporation's share price did drop, it would suggest that investors on the whole believed that there was a significant risk that the corporation's liabilities could exceed its assets. Even if a remote investor had not previously believed that herself, this indication of the view of other investors might give her pause.

None of these points is weakened by the several real-world examples that Professor Grundfest provides, each of which arose in a very different context. He relies primarily on the existence of clientele effects, in which investors with different characteristics tend to choose investments that complement their needs. Professor Grundfest says that "[c]lientele effects . . . are not unusual in modern capital markets," and he cites as examples tax clienteles, dividend clienteles, and leverage clienteles.²⁹⁰ Setting aside the fact that Professor Grundfest's statement that the literature "documents" such clientele effects is more unequivocal than the literature itself,²⁹¹ clientele effects in these contexts would say little about whether similar effects would arise in response to unlimited liability. In each of the cases cited by Grundfest, investors divided themselves into clienteles based on direct or indirect tax effects. In effect, because of differing tax treatments, returns on various classes of equity differed for different investors.²⁹² Those investors then, not surprisingly, chose the

²⁸⁹ See *infra* part VI.B.1.

²⁹⁰ Grundfest, *supra* note 9, at 393.

²⁹¹ Professor Grundfest cites a number of articles in support of this claim. Although some of them do indeed support it, others do not. For example, Grundfest cites one as "displaying direct evidence of clientele effects." *Id.* at 393 n.19 (citing Wilbur G. Lewellen et al., *Some Direct Evidence on the Dividend Clientele Phenomenon*, 33 J. FIN. 1385 (1978)). The authors Grundfest cited, though, concluded it by saying that they were "unable to find in the data much evidence to support the notion that an important dividend-tax-clientele effect is in fact present." Wilbur G. Lewellen et al., *Some Direct Evidence on the Dividend Clientele Phenomenon*, 33 J. FIN. 1385, 1394-95 (1978). Another article did find, as Grundfest notes, a negative correlation between a corporation's financial leverage and its investors' personal tax rates, see John M. Harris, Jr. et al., *Evidence of Financial Leverage Clienteles*, 38 J. FIN. 1125 (1983), but that same article cites another, *id.* at 1131, not cited by Grundfest, in which the authors concluded that "there [was] little indication of a systematic negative relationship between [investor tax] rates and corporate leverage policies," E. Han Kim et al., *Financial Leverage Clienteles: Theory and Evidence*, 7 J. FIN. ECON. 83, 100 (1979). A third article cited by Grundfest is a purely theoretical, rather than empirical, exploration of possible equilibrium relationships between bond term structures and investor classes, defined by transaction costs and taxes. See Jaime Cuevas Dermody & Eliezer Zeev Prisman, 43 J. FIN. 893 (1988).

²⁹² For example, in Lewellen et al., *supra* note 291, the authors examine the relationship between investors' marginal tax rates and the dividend yields of their investments. An intuitively plausible hypothesis is that investors with high tax rates would

equity investments that had the best return for them. This demonstrates only that different investors, with different characteristics, are likely to find different investments relatively more or less appealing; it does not ensure that when the characteristics of an investment change, there will always remain sufficient demand for it so that its price will not change.

An example will make this point more clear. It is quite possible that high-tax-rate investors are more likely than low-tax-rate investors to prefer stocks that provide their return as capital appreciation (taxed later as capital gains), rather than as dividends (taxed now as ordinary income); conversely, low-tax-rate investors may be (relatively) more likely to prefer to receive their returns as dividends. This tells us little about what effect dividend yields have on stock prices. It is possible, for example, that *both* kinds of investors prefer to receive their returns as dividends (perhaps to avoid the risk that those returns might vanish), but that low-tax-rate investors just prefer that more strongly. In that case, the prices of stocks that provide their returns as capital appreciation would be lower than those of stocks that return dividends; the pressure that would lower the prices would be lessened by the existence of high-tax-rate investors, it is true, but it would not be eliminated. The same point applies to unlimited liability. It is likely that risky stocks would be priced lower in an unlimited-liability world than in a limited-liability one, though the existence of remote investors might temper the price drop somewhat.

Furthermore, another factor makes tax-related clientele effects a poor analogy to unlimited liability: uncertainty.²⁹³ The underlying sources of the clientele effects that Professor Grundfest discusses—that is, the tax treatment of corporate dividends and capital appreciation—are well-defined and certain. Investors choosing investments based on these tax considerations do not need to wonder whether they will benefit. When the effects of investors' decisions are uncertain, however, investors cannot rely on those effects. This is true even for the kinds of tax-related decisions involved in Professor Grundfest's clientele effects, as was apparent in investors' unwillingness to shift from partnerships to limited-liability companies until the Internal Revenue Service issued a ruling on

prefer to avoid stocks that provide returns in the form of dividends subject to those tax rates (and instead would prefer to receive their returns in appreciation of the stock price, which would be taxed at a lower capital-gains rate). If this hypothesis is true, one would expect to see more low-dividend-yield stocks owned by high-tax-rate investors, and high-dividend stocks would be owned disproportionately by low-tax-rate investors. As described briefly *supra* note 291, the evidence regarding the existence of these kinds of clientele effects is inconclusive.

²⁹³ I refer here to legal uncertainty, as distinguished from financial uncertainty.

the tax treatment of such companies.²⁹⁴ This phenomenon is also seen in investors' preference for incorporation in Delaware as a result of Delaware's well-developed corporate law, which reduces the uncertainty of the relationships among shareholders, their corporations, and the corporations' officers and directors.²⁹⁵

Remote investors in an unlimited-liability corporation would be subject to considerable uncertainty regarding the possibility that their assets could be reached. That would obviously be the case initially, until courts' views on enforcing unlimited-liability judgments became clear. However, clarity might in fact never be achieved, because courts' treatment of unlimited-liability cases might differ with the circumstances of the particular corporations and shareholders involved. Furthermore, shareholders would also be subject to uncertainty resulting from their own activities. In determining whether they were willing to subject themselves to unlimited liability, shareholders would have to consider whether they might in the future establish contacts in the U.S. that would, as a consequence, make them subject to jurisdiction here.²⁹⁶ All of

²⁹⁴ See, e.g., Marybeth Bosko, Note, *The Best of Both Worlds: The Limited Liability Company*, 54 OHIO ST. L.J. 175, 179 (1993) (noting the initial uncertainty regarding the Internal Revenue Service's treatment of limited-liability companies (LLCs) and observing that "[g]iven the uncertainties surrounding the LLC, it is not surprising that most companies concluded that the risks involved with the LLC were not worth taking").

²⁹⁵ See, e.g., EASTERBROOK & FISCHER, *supra* note 162, at 213 (noting that Delaware's success in attracting incorporations comes from, among other things, "its large body of precedents").

²⁹⁶ Uncertainty is only one example of informal mechanisms that could inhibit investment. Informal pressure from U.S. interests that disapproved of foreign investors evading unlimited liability is another possibility, as is suggested by an example offered by Professor Grundfest. See Grundfest, *supra* note 9, at 393-94. He describes an investment strategy pursued by Japanese insurance companies seeking to meet a Japanese regulatory requirement that policy payments be made from current income, rather than capital gains. To meet this requirement, the insurance companies purchased U.S. stocks prior to the stocks' payment of dividends, then resold them almost immediately *ex dividend*, i.e., without the right to receive the dividend. At one time, these "dividend capture" transactions made up a significant fraction of all New York Stock Exchange volume, but the volume of such transactions has declined. According to Professor Grundfest, the decline has occurred "because Japanese authorities have amended their insurance regulations to eliminate insurers' incentives to engage in these dividend-stripping transactions." *Id.* at 394.

In fact, though, it appears that the reduction in dividend capture activity was due not so much to formal regulatory action as to more informal disapproval in the United States. The high dividend-capture volume—up to twenty-five or thirty percent of overall volume on some days—raised concerns that it was skewing market indicators. William Power &

these uncertainties would discourage remote investors from investing in risky equity.

2. Risk of an Unlimited-Liability Judgment and Equity Prices

Uncertainties in the accessibility of investors' assets would not only discourage investors from investing in risky stocks, they would also lower the prices that investors would be willing to pay. The key point here is that whether the assets of a given shareholder are subject to attachment is rarely answerable either "yes" or "no." Instead, the accessibility of shareholder assets occupies a continuum from very accessible—as for forum-state residents—to effectively inaccessible—as for a foreign investor with few assets.²⁹⁷ Unlimited liability would affect the price that an investor is willing to pay based on the investor's position on this continuum. Investors who believed that their assets were fully accessible would reduce the price that they were willing to pay by their discounted estimate of the full unlimited-liability risk. Investors who believed that they were fully "attachment-proof" would, as Professor Grundfest says, be willing to pay the same price that they would pay in a limited-liability regime. The vast majority of investors, who would fall between these extremes, would be willing to pay a price somewhere between the limited-liability and full-unlimited-liability prices.

Thus, it is an oversimplification to say that the existence of "attachment-proof" investors would evade unlimited liability. It is all a matter of degree. The unlimited-liability price of risky equity, and hence the effectiveness of unlimited liability for that equity, would depend on an overall measure of the accessibility of the assets of both remote and non-remote investors in that equity. To claim that all such investors will be purely "attachment-proof" is to

Michael R. Sesit, *Mania for Dividend Capture Subsides*, WALL ST. J., May 12, 1989, at C1. As reported in the Wall Street Journal:

The Japanese got the message. "It got people annoyed. The Japanese just got tired of the bad publicity," says market analyst Laszlo Birny, president of Birny Associates Inc., New York. Japanese brokers say that Japan's Ministry of Finance passed the word that investors should tone down their capture activity, and they did.

Id. The same article notes that Japanese insurers can now use some capital gains to make policy payments, but suggests that that was a lesser factor in promoting the change. *See id.*

²⁹⁷ For example, the assets of mutual funds, which generally would have continuous and systematic dealings with parties in all states, would therefore be accessible in all states. The accessibility of the assets of other U.S. and foreign shareholders would depend on the shareholders' specific dealings with the forum state, and with their states' treatment of the unlimited-liability issue.

beg the question. Moreover, as is described in the next section, even if there were a class of purely "attachment-proof" investors, that would not necessarily avoid the effects of unlimited liability.

3. Price Effects of an Illiquid Risky-Equity Market

Even assuming that there would be some investors who were willing to invest in risky equity subject to unlimited liability, and even if some of those investors would value their risk of being subject to unlimited liability at zero, that would not establish that the prices for that risky equity would not drop as a result of the imposition of unlimited liability. The simple fact that the pool of investors who would be willing to invest in risky equity at prices unaffected by the risk under unlimited liability would necessarily be smaller than the pool of investors who would be willing to invest at that price if their liability were limited could lower the price.²⁹⁸ That is so because investors who were willing to buy unlimited-liability equity at a limited-liability price could only sell the equity (at that price) to others in the same position. That would reduce the liquidity of the equity, and liquidity has value, so the price would drop.

The most straightforward way to look at the liquidity issue is to realize that investors who will find it difficult to sell their stocks will require a higher rate of return than they would in the absence of that difficulty.²⁹⁹ "Put differently,

²⁹⁸ Professor Leebron, in his article on unlimited liability, noted the liquidity problem in response to the suggestion that risky equity would be owned by those with insufficient wealth to make pursuing their assets worthwhile:

[M]any markets function where the value of the product depends on some circumstance of the buyer, such as wealth. Thus, it is not correct to assert that there will be more than one market price for a share. Rather, shareholders with less wealth exposure may be able to purchase shares for less than they value them. Of course, if there are enough such shareholders who are willing to acquire more shares, then the value of the firm will rise and shareholders with greater wealth exposure will sell. But the suggestion that such shares would simply be accumulated by the poorest investors is not plausible. Such investors do not have the assets for such accumulations, and they are likely to be just as unwilling to risk all their wealth on a single investment as a wealthy shareholder. In short, the problem is not that there will be more than one price; rather, as the wealth effect becomes significant, the market will become thinner and eventually illiquid.

Leebron, *supra* note 1, at 1608–09 (footnote omitted).

²⁹⁹ See Yakov Amihud & Haim Mendelson, *Liquidity and Cost of Capital Implications for Corporate Management*, in *THE REVOLUTION IN CORPORATE FINANCE* 89, 89 (Joel M. Stern & Donald H. Chew, Jr. eds., 2d ed. 1992) ("[I]nvestors price securities according to

given two assets with the same cash flows but with different liquidity, investors will pay less for the asset with the lower liquidity.”³⁰⁰ Yakov Amihud and Haim Mendelson examine the consequences of this issue for corporate issuers. They point out that low liquidity of an issuer’s offerings will “represent a significantly higher cost of capital.”³⁰¹ The implication of this higher cost of capital is that a corporate issuer of risky equity cannot escape a drop in its price due to unlimited liability by moving its equity ownership overseas if the smaller size of the market will make it difficult to sell its shares, or for its investors to sell theirs.

Obviously, there is no empirical evidence as to how much the imposition of unlimited liability would reduce the size of the equity market for risky stocks.³⁰² However, Amihud and Mendelson provide a useful analogy. They refer to the issue by publicly-traded corporations of “letter” stocks, stocks that are identical to the corporations’ publicly-traded stocks, except that they are not registered with the Securities and Exchange Commission and thus cannot be publicly traded.³⁰³ Because of letter stocks’ restricted trading, Amihud and Mendelson say, “[e]vidence suggests that letter stocks sell at a discount of about 25% relative to their publicly-traded counterparts.”³⁰⁴ Another,

their returns *net* of trading costs; and they thus require higher returns for holding less liquid stocks to compensate them for the higher cost of trading.”).

³⁰⁰ *Id.*

³⁰¹ *Id.* at 90.

³⁰² Liquidity is, however, one of the arguments for limited liability. *See, e.g., id.* at 95, stating:

By limiting stockholders’ losses to the amount of their investment, the limited liability provision increases the liquidity of stocks. Without limited liability, investors would trade stocks very cautiously, the market would become thin and the bid-ask spreads would be considerably higher since buyers and sellers would set prices to protect themselves.

Id.

³⁰³ *Id.* at 91.

³⁰⁴ *Id.* Brealey and Myers make a similar point regarding corporate debt: “Lenders in private placements have to be compensated for the risks they face and for the costs of research and negotiation. They also have to be compensated for holding an illiquid asset.” RICHARD A. BREALEY & STEWART C. MYERS, *PRINCIPLES OF CORPORATE FINANCE* 342 (3d ed. 1988). Brealey and Myers state that a typical interest rate differential is “on the order of 50 basis points or .50 percentage points,” *id.*, which, for an interest rate of 10 percent in 1988, translates to a five percent lower return.

somewhat more distant analogy is available in an international context.³⁰⁵ France has a law forbidding the removal from the country of certain national treasures, among which are some paintings. The owner of van Gogh's *Garden at Auvers* sought to sell the painting outside of France, where he believed that it would receive a higher price than in France. In 1989, however, the French Culture Ministry declared *Garden at Auvers* a national treasure, and the owner was forced to sell it in Paris for \$9.5 million. The seller then brought suit seeking the difference in value between the price he was able to get selling the painting in France and that which he would have received could he have sold in a broader market, and the French court awarded him \$72.7 million to cover the difference between the painting's value here and abroad.³⁰⁶ This scenario is analogous to the one Professor Grundfest suggests for risky equity, with sales of that equity confined to foreign investors. The two markets are considerably different, of course, but this story suggests the potential magnitude of liquidity effects.

Now, I do not claim here that either the 25% price reduction for letter stocks or the 88% price reduction for the van Gogh is an accurate estimate of the illiquidity price reduction that would occur for risky equity. I do suggest, though, that one cannot simply assert that confining risky equity purchases to a subset, perhaps a small subset, of foreign investors will have no effect on the prices of that equity. Instead, to show that the concentration of risky equity in the hands of remote investors will not affect the price of the equity, one must show that the pool of such investors is sufficiently large to avoid these liquidity effects. That showing has not been made

B. *The Liability-Limiting Mechanisms*

Someone must own the equity of risky corporations, and under unlimited liability whoever did so would bear the risk of liability. This consideration is important when considering the specific mechanisms that Professor Grundfest proposes for avoiding unlimited liability. His proposals, with one exception, rely on the claim that the price of risky equity would not change under unlimited liability because it would all be owned by "attachment-proof" investors. As the preceding sections showed, that claim is suspect, and the following sections argue that the proposals that rely on it are therefore also questionable. The one mechanism Grundfest suggests that does not rely on the claim that equity prices would be unchanged under unlimited liability is a

³⁰⁵ This example is discussed in Alan Riding, *A Van Gogh Becomes a Cause Célèbre*, N.Y. TIMES, Apr. 18, 1994, at C3.

³⁰⁶ *Id.*

straightforward shifting of corporate financing from equity to debt.³⁰⁷ That is, he would have corporate creditors bear more of the risk of corporate failure under unlimited liability than they do under limited liability. However, debtholders, like equityholders, will not bear risk for free; therefore, this mechanism too would raise a risky corporation's capital costs, thus promoting at least the deterrent, if not the compensatory, goals of unlimited liability.

1. *Arbitrage with Remote Shareholders*

Professor Grundfest's arbitrage argument is that, given the existence of enough remote investors to purchase all available risky equity,³⁰⁸ those investors could swap the equity returns from their risky equity (minus the unlimited liability) for the equity returns of safe equity owned by attachable investors, thus allowing both to replicate the limited-liability market portfolio.³⁰⁹ The purpose of this arbitrage would be to allow the remote investors to rebalance their portfolios, so that even if they held only risky equity, they could share in the returns of safe equity. Non-remote investors, on the other hand, could share in the returns of risky equity without incurring the risk of unlimited liability. This arbitrage plan would only work, however, if, as Grundfest assumes, remote investors were willing to pay exactly the same price for risky equity under unlimited liability as they would pay under limited liability. To the extent that risky equity prices dropped under unlimited liability, as the preceding sections argued they would,³¹⁰ non-remote investors would have less reason to swap for the risky returns.³¹¹

Furthermore, it would not be enough that remote investors valued their risk from unlimited liability at zero; non-remote investors would have to agree with that evaluation. If non-remote investors believed that remote investors were at risk of an unlimited-liability assessment, they would pay less for the remote investors' returns on risky equity. That is, the non-remote investors

³⁰⁷ This approach is discussed in more detail in the text accompanying notes 314–15 *infra*.

³⁰⁸ See *supra* note 283.

³⁰⁹ See Grundfest, *supra* note 9, at 401.

³¹⁰ See *supra* part VI.A.

³¹¹ That is because the lower returns on the unlimited-liability risky equity would make it less attractive than it was when liability was limited. Therefore, non-remote investors would probably prefer the returns of safe equity, which would remain the same under unlimited liability as it was under limited liability. It is still possible, though, that non-remote investors would want the returns of unlimited-liability for other purposes, such as diversification.

would discount the value of the risky equity for the unlimited-liability risk that they perceived, regardless of whether any risk was perceived by the remote investors. This problem could perhaps be avoided if the remote investors agreed to swap the returns of equity net of any unlimited-liability assessments. It is possible, though, that if non-remote investors insisted on such a condition, the remote investors might themselves re-evaluate their assessments of unlimited-liability risk.

Finally, the arbitrage plan is also somewhat implausible for another reason. Its basic idea is that non-remote investors would use arbitrage to obtain the returns of risky equity without risking unlimited liability. In other words, the claim is that investors who wanted to invest in a particular corporation would, at the same time, believe that the probability that the corporation's liabilities would exceed its assets was sufficiently high to justify incurring the transaction costs of the arbitrage to avoid unlimited liability. This scenario is not impossible, of course. It could be that very low transaction costs, coupled, perhaps, with a low probability of a high-magnitude loss, would lead investors to behave in this way. It seems more likely, though, that if investors thought that the chances of bankruptcy were high enough to require incurring special costs to avoid its effects, they would simply select another investment.

2. Adjustment of Debt/Equity Ratios

Professor Grundfest also suggests that corporations could issue a variety of forms of debt in place of newly-expensive unlimited-liability equity. This suggestion seems to indicate some uncertainty on the part of Professor Grundfest as to whether the existence of remote investors would actually allow the financial markets to avoid unlimited liability—if so, why the need to shift to debt? Indeed, Grundfest says that “issuers will have an incentive to respond to market signals by shrinking the pool of equity that is potentially subject to proportionate liability because capital in that form will become relatively more expensive.”³¹² Setting this issue aside, though, Professor Grundfest's suggestions along this line take two basic approaches: the issuance of debt securities that mimic the returns of equity, and a straightforward shifting of the corporate balance sheet from equity to debt.

Professor Grundfest's first approach, the issuing of debt convertible to equity, is of little force if, as was argued above,³¹³ risky equity would become more expensive under unlimited liability. If a risky corporation's equity prices were lower as a result of unlimited liability, the equity-conversion element of

³¹² Grundfest, *supra* note 9, at 405.

³¹³ See *supra* part VI.A.

convertible debt would reflect that lowered price. Investors would be willing to pay proportionately less for the convertible debt, raising the corporation's cost of capital just as higher equity prices themselves would. Hence, the convertibility element of Professor Grundfest's proposed equity-to-debt shift adds little; the key element is the shift from equity to debt.

A corporation would shift from equity to debt only to the extent that doing so would not raise its cost of capital. An equity-to-debt shift would, however, be especially likely to raise capital costs for exactly the high-tort-risk corporations for which Professor Grundfest suggests it. A risky corporation must compensate its investors for the risk they incur by promising them a high rate of return. It is usually more efficient for a risky corporation to offer that return through an equity claim on its residual value than through fixed (and high) interest payments, for several reasons. First, the high risk is presumably balanced by a high potential payoff, and equityholders, unlike debtholders, will share in that payoff. Second, a debt-heavy structure is likely to make it difficult for a risky corporation to meet its interest obligations: "Other things equal, distress is more likely for firms with high business risk. That is why such firms generally issue less debt."³¹⁴ Finally, it is typically easier for equity investors, rather than creditors, to diversify to reduce the risks that they face.³¹⁵ These are the basic reasons why equity markets develop in the first place, and those reasons are stronger, not weaker, in the case of risky corporations.

3. *Creation of New Financial Instruments*

Professor Grundfest's final approach, the creation of new financial instruments that would formally be debt but that would mimic the value of risky equity issues, suffers from the same problem as the convertible-debt approach discussed above: it depends purely on the maintenance of risky equity prices at their limited-liability levels. If risky equity's value declined as a result of unlimited liability, the price of any financial instrument based on the equity's value would also decline. That is, like the arbitrage and convertible-debt approaches, this one would not be an independent means of avoiding limited liability, but would simply be a means to package risky equity—whatever its characteristics under unlimited liability might be—in another form. Some investors still would have to own the equity, and, as described above,³¹⁶

³¹⁴ BREALEY & MYERS, *supra* note 304, at 435.

³¹⁵ That is true both because equity claims are often smaller than corporate debt claims and because the liquidity of equity is typically greater than that of debt.

³¹⁶ See *supra* part VI.A.

Professor Grundfest has not shown that they would be willing to do so without compensation for the risk and liquidity problems it would present.

C. An Unlimited-Liability Analogy: Short Sales

It is useful at this point to turn from the theory of the preceding sections to a real-world analogy to unlimited liability: short stock sales.³¹⁷ The sale of a share of stock short is the reverse of the purchase of a share of unlimited-liability stock. Both present a similar risk of unlimited liability: the stock purchase if the price goes down, the short sale if it goes up. It is worthwhile, therefore, to consider whether the same liability-evasion strategies that Professor Grundfest says would be used by unlimited-liability shareholders are also used by short-sellers. The question is an especially interesting one because the creditors in the case of a stock purchase are in a sense better protected than those in a short sale, even with the S.E.C.'s short-sale margin requirements.³¹⁸ The creditors in the case of a stock purchase are the corporation's creditors, who are protected by the amount that the purchaser has invested, *i.e.*, the value of the stock.³¹⁹ The creditor in the case of a short sale is the seller's broker, who is responsible for providing the stock when the sale is consummated if the seller does not.³²⁰ The broker is required by the S.E.C. to maintain a margin account for the seller, which is designed specifically to ensure that there will be sufficient funds available to purchase the stock, even if its price rises.³²¹ The

³¹⁷ To sell a share of stock short is to sell a share that one does not own. The short seller hopes that the price of the stock will go down, so that he can buy it later, to meet the sale obligation, at the lower price, and keep the difference as his profit.

³¹⁸ See *infra* text accompanying notes 320-26.

³¹⁹ This assumes that the market has valued the corporation's going-concern value accurately. If the corporation were liquidated, its liquidation value would probably be somewhat less than the corporation's market capitalization.

³²⁰ See Reg. T § 2(b), 12 C.F.R. § 220.2(b) (1995) (defining brokers and dealers as creditors for the purpose of the short-selling margin requirements).

³²¹ There is nothing to prevent brokers from agreeing with their customers on margin requirements, either as to amount or time, that are more strict than those required by regulation, and they typically do so. But the broker still may not be able to prevent the customer's margin account from being exhausted, either because a price rise occurs too rapidly or because the broker does not want to damage its relationship with its customer by liquidating the customer's position too quickly. I have been informed by a member of the brokerage industry that after price rises brokers are in fact sometimes left liable to make up their customers' short positions.

Nevertheless, the fact that the S.E.C. *requires* brokers to maintain margin accounts at a certain level is interesting in itself. The S.E.C. requirements suggest that brokers might not

question, then, is how well does the protection offered by the margin requirements compare with the protection provided by a simple stock purchase?

The S.E.C.'s margin regulations require that a short-seller deposit only 50% more than the market value of the stock.³²² Hence, the seller's broker is protected against a price rise of only 50% of the initial investment, whereas in the case of a stock purchase creditors are protected against a price drop of 100% of the initial investment. The comparison is complicated somewhat, however, by margin maintenance requirements. If the price of a stock sold short goes up, the broker can request the short-seller to increase the amount in his margin account to maintain the 50% margin.³²³ The short-seller has five days to meet the margin call,³²⁴ after which time the seller may liquidate the seller's securities to meet the requirement.³²⁵ Therefore, the broker is really only exposed to stock price increases beyond the 50% margin requirement if those increases take place in less than five days.³²⁶ There are, however, events that, relatively frequently, cause large, rapid stock price increases: tender offers. The premiums offered over market prices in tender offers average approximately 50%.³²⁷ The market prices then typically rise rapidly to near the

do so on their own. That, in turn, suggests that brokers are not especially concerned about evasion strategies.

³²² Reg. T § 5(b)(1), Supp., 12 C.F.R. §§ 220.5(b)(1), 220.19(c) (1995). The New York Stock Exchange generally requires that if the value of the stock goes up, the margin level be maintained at the market value. N.Y. Stock Exchange Rules 431(c)(2)-(4), *reprinted in* N.Y. Stock Exchange Guide (CCH) ¶ 2431.

³²³ Reg. T § 4(c), 12 C.F.R. § 220.4(c) (1995).

³²⁴ Reg. T § 4(c)(3), 12 C.F.R. § 220.4(c)(3) (1995); Reg. T § 2(w), 12 C.F.R. § 220.2(w) (1995); SEC Rule 15c6-1, 17 C.F.R. § 240.15c6-1 (1995).

³²⁵ Reg. T § 4(d), 12 C.F.R. § 220.4(d) (1995).

³²⁶ It should be noted that events that would create tort liability for unlimited-liability shareholders would also probably take place over a short time. That would be true of catastrophic torts, like the Bhopal disaster, and could also be true for other torts under the rules proposed by Professors Hansmann and Kraakman for determining whether tort liability would attach to shareholders. *See supra* note 4.

³²⁷ *See, e.g.,* Robert Comment & Gregg A. Jarrell, *Two-Tier and Negotiated Tender Offers: The Imprisonment of the Free-Riding Shareholder*, 19 J. FIN. ECON. 283, 297 (1987) (in tender offers for any or all shares between 1981 and 1984, mean premiums were 50.7% when offers were negotiated with target firm management and 68.0% when they were not, for an overall average of 56.1%); *Grand Metropolitan Launches Bid of \$5.12 Billion for Pillsbury Co.*, WALL ST. J., Oct. 4, 1988, at A3 (53.8% premium); *Philip Morris Cos. Is Bidding \$90 a Share for Kraft Inc. in \$11 Billion Tender Offer*, WALL ST. J., Oct. 18, 1988, at A3 ("50% premium"); *American Home Offers \$8.5 Billion for Cyanamid*, WALL ST. J., Aug. 3, 1994, at A3 ("nearly a 50% premium"); *see also* Litton Indus., Inc. v. Lehman Brothers Kuhn Loeb Inc., 967 F.2d 742, 749 (2d Cir. 1992) (stating that "[t]he rule of

tender-offer price, or even to a higher price if competing bidders are expected.³²⁸ Tender offers therefore present exactly the sort of sudden price increase of 50% or more of a stock's market price that exposes short-sellers, and their broker-creditors, to unlimited liability

It thus seems that short-selling would present the same sort of opportunity for evasion tactics that Professor Grundfest claims would occur on the imposition of unlimited liability. Although remote investors would probably not be likely candidates for evasion, because the contractual short-sale arrangement between seller and broker would probably be enforced by even foreign courts, there are other possibilities. Why, for example, do we not see

thumb for calculating the minimum acceptable offer [in 1982-1983] was a 50% premium above the pre-announcement price of the target shares") (citations omitted).

³²⁸ See, e.g., Steve Swartz & Judith Valente, *Odds Are Against Kraft in Takeover Fight*, WALL ST. J., Oct. 19, 1988, at A3 (after Philip Morris Cos. offered \$90 per share for Kraft Inc. after close of trading on previous day, Kraft shares rose from \$60.125 to \$88.25, or 47.2%, in one day); *Pillsbury May Have Few Options As It Considers Grand Met Offer*, WALL ST. J., Oct. 5, 1988, at A4 (after Grand Metropolitan PLC offered \$60 per share for Pillsbury Co. after close of trading on previous day, Pillsbury shares rose from \$39 to \$57, or 46.1%, in one day); *American Home Offers \$8.5 Billion for Cyanamid*, WALL ST. J., Aug. 3, 1994, at A3 (following American Home Products Corporation's surprise announcement of a \$95-per-share bid for American Cyanamid Co. after trading in American Cyanamid was halted on the New York Stock Exchange, American Cyanamid's share prices rose from \$63.75 to \$93 in after-hours trading, an increase of 45.9%); *Dow Jones Seeks To Buy Rest of Telerate for \$18 a Share, or Total of \$576 Million*, WALL ST. J., Sept. 22, 1989, at A5 (after Dow Jones & Co. proposed to buy share of Telerate Inc. for \$18 per share, Telerate's shares on the New York Stock Exchange closed at \$20.375).

As the examples just cited suggest, the large majority of the stock price increase takes place within a five-day period. This is further demonstrated by a study by the Office of the Chief Economist of the S.E.C. of 172 exchange-listed tender offers from 1981 to 1985. See OFFICE OF THE CHIEF ECONOMIST, S.E.C., STOCK TRADING BEFORE THE ANNOUNCEMENT OF TENDER OFFERS: INSIDER TRADING OR MARKET ANTICIPATION? (1987). This report examined the excess price returns of the target companies' stocks in the twenty days before and five days after the news of the offer broke, and found that 80.6% of the excess returns took place in the five trading days prior to the day news broke. *Id.* Table 1. For the 103 tender offers that were "secret" (i.e., for which no rumors of a takeover had been publicly reported), the percentage of the increase in those five days was even greater: 89.0%. *Id.* Table 3. And for twenty secret offers in which the bidders had acquired relatively small percentages of the target stock (so that acquisition of large blocks could not have been used as a signal), the entire price rise took place in five days. *Id.* Table 5. Hence, for a significant fraction of offers, the relevant price increase takes place in a period shorter than that in which a margin call must be met. In any event, at least one case has alleged that a pre-offer price run-up would simply require a higher offer so as to maintain the expected 50% premium. See *Litton Indus., Inc.*, 967 F.2d at 746.

short sales made by limited-liability corporations established with financing just sufficient to meet the initial margin requirement of the short sale? Such corporations could provide the returns of the short sale to its investors if the stock price went down, but could use their limited liability to shield their investors from losses exceeding the margin if the price went up. The reason this does not occur, I suggest, is that the transaction costs of such an arrangement would exceed the probable losses on the short sales. Even though a stock's price does occasionally increase in value by more than 50%,³²⁹ such events are not common, and one would have to make these sorts of evasion arrangements for *each* stock that one sold short. If one could predict for which stocks evasion would be necessary—that is, which stocks were likely to greatly increase in price—those stocks would not be sold short at all.

The same point applies to purchases of unlimited-liability stocks. Although rapid stock price rises of more than 50% are not common, neither are corporate insolvencies as a result of tort liability.³³⁰ Therefore, it seems unlikely that Professor Grundfest's evasion strategies would be perceived by shareholders as worth their transaction costs. This is especially so because investors purchase stock only if they expect its price to go up, not if they expect it to drop, let alone to drop below zero.³³¹ Therefore, investors are unlikely to believe that the chance that a stock in which they invest will subject them to an unlimited-liability judgment is sufficiently large to justify incurring even quite low transaction costs to avoid it.³³² This is borne out by the

³²⁹ It is true that if the price of the stock sold short increased, the short-selling corporation's broker would issue a margin call, *see supra* note 323 and accompanying text, and that if the corporation did not meet it, the broker could buy the shares before an actual loss occurred. But if the stock experienced a dramatic and rapid price increase—analogueous, in the unlimited liability case, to a catastrophic tort—the broker could be subject to the losses beyond the initial margin requirement.

³³⁰ In fact, in the examples that come most readily to mind, Johns-Manville's liabilities for asbestos injuries and A.H. Robins's as a result of the Dalkon Shield, the companies concerned filed for bankruptcy as much for tactical reasons as because of insolvency. *See generally* Frank R. Kennedy, *Creative Bankruptcy? Use and Abuse of the Bankruptcy Law—Reflection on Some Recent Cases*, 71 IOWA L. REV. 199, 202–10 (1985) (discussion Johns-Mansville bankruptcy); RICHARD B. SOBOL, *BENDING THE LAW: THE STORY OF THE DALKON SHIELD BANKRUPTCY* (1991). In other cases of extremely large tort liability, such as Union Carbide's at Bhopal and the Exxon Valdez, no insolvency resulted.

³³¹ This is so just as short-sellers would not sell a stock short if they believed that its price would rise.

³³² *See* Leeborn, *supra* note 1, at 1573 ("Within the range of probabilities and magnitudes of loss that are likely to characterize an unlimited liability regime, the more pronounced effect of unlimited liability will probably be on the riskiness of the investment

example, discussed previously,³³³ of American Express when it was an unlimited-liability company. American Express was at one time sued for an amount considerably more than its net assets,³³⁴ and the price of the stock dropped by 43%,³³⁵ but it continued to trade, even among sophisticated and well-capitalized investors.³³⁶ There was apparently no evidence that investors took steps to avoid possible liability.³³⁷

Hence, both the short-sale analogy and the example of American Express suggest that the imposition of unlimited liability would not necessarily prompt investors to seek mechanisms by which they could avoid the risk of unlimited liability. These examples, of course, are not perfect analogies to the unlimited liability proposal of Professors Hansmann and Kraakman. Short sales are in some significant ways different from stock purchases,³³⁸ and the American Express events took place in 1963,³³⁹ when the financial markets were very different. Nevertheless, these examples are of unlimited liability in the real world, and as such are perhaps more telling than theory. The story they tell is one of investors who, instead of incurring additional costs to avoid a risk of unlimited liability that they perceive as slight, simply accept that risk as they do many others.

rather than on the expected value."). A shareholder can, of course, diversify to reduce the significance of unlimited-liability risk.

³³³ See *supra* text accompanying notes 50–55.

³³⁴ See Grossman, *supra* note 29, at 81–82 & n.61.

³³⁵ *Id.* at 82 n.63.

³³⁶ *Id.* at 81–82.

³³⁷ Grossman describes none, and the continued investment in American Express by at least one mutual fund suggests that there was none. See *id.* at 82. Grossman notes that the American Express entity that was potentially liable was actually an incorporated subsidiary of the publicly-owned corporation. *Id.* at 81–82 n. 61. Grossman indicates that American Express treated the obligation as one of the parent corporation, *id.*, but it is unclear whether the parent corporation undertook the obligation in a way sufficiently formal to make its investors liable. This issue, though, is of little importance for present purposes, where the point is that even with the potential of a large judgment against American Express, enough investors viewed its prospects optimistically to keep its price at more than one-half of its pre-suit price. It is unlikely that those investors, while believing American Express to be a good investment at that price, would have been willing to incur transaction costs to avoid potential unlimited liability.

³³⁸ See *supra* notes 322–23.

³³⁹ Grossman, *supra* note 29, at 81.

VII. CONCLUSION

Unlimited shareholder liability would radically change the way we look at corporations. In an unlimited-liability world, one part at least of the veil between corporation and shareholder would no longer exist. As a result, the relationship between corporation and shareholder would be, both in law and in fact, much closer than it is currently. The two parts of this change—the legal and the factual—would reinforce each other. The legal change would be reflected in court decisions enforcing unlimited liability. Regardless of the exact contours that decisions in this area took initially, there would be at least some shareholders—mutual funds, for example—whom it would be both jurisdictionally and practically feasible for tort creditors to pursue.³⁴⁰ If only a few unlimited-liability judgments against these shareholders were obtained and enforced, almost all shareholders would examine their corporate investments with a new attention.³⁴¹ They would investigate the business activities of the corporations in which they owned shares, and if they believed those activities presented a risk of unlimited liability, they would bear that risk only for a price.³⁴² These changes in shareholder behavior would make more apparent—and more real—the role of shareholders in influencing corporate behavior, and it would in turn be acknowledged by the courts in an increased willingness to enforce unlimited liability.

The preceding description of a world of unlimited shareholder liability perhaps presents the acceptance of liability as a bit more inevitable than it actually would be. However, I believe that this description is more plausible than those of Professors Alexander and Grundfest, who discuss unlimited liability as if it would have no effect at all on shareholders' investment decisions or on courts' treatments of the corporate-shareholder relationship. Professor Alexander claims that shareholders under unlimited liability would lack "even knowledge of" the activities of the corporations in which they invest.³⁴³ Professor Grundfest claims that "stock market prices would not fall to reflect the risks associated with [unlimited] liability."³⁴⁴ Both of these assertions reflect an assumption that shareholders would not react at all to the imposition of unlimited liability. Although that assumption conflicts with what

³⁴⁰ See *supra* parts III & V.

³⁴¹ See *supra* part IV.

³⁴² See *supra* part VI.

³⁴³ Alexander, *supra* note 9, at 409. See also *supra* text accompanying note 15.

³⁴⁴ Grundfest, *supra* note 9, at 393 (footnote omitted). See also *supra* text accompanying notes 20–23.

little evidence we have of shareholder reactions to unlimited liability³⁴⁵ and with normal expectations regarding shareholder behavior,³⁴⁶ it is only by relying on it that Professors Alexander and Grundfest can maintain their rather claims that a state's imposition of unlimited liability would be entirely ineffective.³⁴⁷ If one accepts the more realistic view that shareholders—and courts—would respond to a fundamental change in the legal definition of a corporation, one concludes that unlimited liability could further the goals of both tort law and corporate law.

³⁴⁵ See Grossman, *supra* note 29, at 81–82 & n.63 (noting that when American Express, an unlimited-liability company at the time, was sued for an amount greater than its net assets, its share prices dropped by 43%). See also *supra* text accompanying notes 333–337.

³⁴⁶ See *supra* parts IV.A & VI.A.

³⁴⁷ See Alexander, *supra* note 9, at 444 (“Taking a procedural view of the proposal to implement unlimited shareholder liability through state tort law lead to the conclusion that this approach simply cannot work.”); Grundfest, *supra* note 9, at 425 (“Capital markets . . . synthesize limited liability pricing in a[n] [unlimited] liability world.”).